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5118
No. 9735

United States
Circuit Court of Appeals

For the Ninth Circuit.

GEORGE D. MARTIN, as Internal Revenue Agent
in Charge for the Sixth United States Internal
Revenue Collection District of California,
Appellant,

vs.

CHANDIS SECURITIES COMPANY and H. E.
DOWNING, as Assistant Secretary of Chandis
Securities Company,

Appellees.

Transcript of Record

**Upon Appeal from the District Court of the
United States for the Southern District
of California, Central Division.**

FILED

MAY - 1 1941

PAUL P. O'BRIEN,
CLERK



United States
Circuit Court of Appeals

For the Ninth Circuit.

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in Charge for the Sixth United States Internal
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INDEX

[Clerk's Note: When deemed likely to be of an important nature, errors or doubtful matters appearing in the original certified record are printed literally in italic; and, likewise, cancelled matter appearing in the original certified record is printed and cancelled herein accordingly. When possible, an omission from the text is indicated by printing in italic the two words between which the omission seems to occur.]

	Page
Affidavit of Charles W. Donnally.....	73
Affidavit of H. E. Downing (March 19, 1940) (for detailed index see "Notice of Motion to Quash" etc. below).....	24
Affidavit of H. E. Downing, Counter (May 14, 1940)	150
Affidavit of H. E. Downing (April 19, 1940).....	136
Affidavit of Warner E. Williams (May 9, 1940)	148
Affidavit of Warner E. Williams (April 6, 1940)	76
Exhibits to Affidavit:	
1—Letter dated November 25, 1931.....	80
2—Protest to Internal Revenue Agent...	87
3—Letter dated March 28, 1932.....	90
4—Letter dated April 4, 1932.....	92
5—Memo. from George M. Thompson...	95
6—Income Tax Return for 1929.....	100
7—Income Tax Return for 1930.....	112
9—Corporation Income Tax Return for 1923	125

Index	Page
Affidavit, Counter, of H. E. Downing (May 14, 1940)	150
Appeal:	
Designation of Appellant of Record on (Circuit Court of Appeals).....	258
Designation of Appellee of Record on (Circuit Court of Appeals).....	263
Notice of	157
Order Extending Time on.....	159
Attorneys, Names and Addresses of.....	1
Certificate of Clerk to Transcript of Record.....	163
Counter Affidavit of H. E. Downing.....	150
Designation, Appellant's, of Record on Appeal (Circuit Court of Appeals).....	258
Designation, Appellee's, of Additional Portions of Record on Appeal (Circuit Court of Appeals)	263
Names and Addresses of Attorneys.....	1
Notice of Appeal.....	157
Notice of Motion to Quash Order for Production of Records.....	19
Affidavit of H. E. Downing.....	24
Exhibits to Affidavit:	
1—Letter of Commissioner.....	37
2—Letter in Reply.....	38

Index	Page
3—Copy of Summons Duces Tecum	40
4—Letter of H. E. Downing to Martin	41
5—Stipulation of Facts.....	43
6—Opinion, Board of Tax Appeals	48
7—Findings of Fact and Opinion...	58
8—Commissioner's Letter of Final Determination	67
Opinion, Memorandum	152
Order for Production of Records.....	13
Order Continuing Return Date of Order for Production of Records.....	16, 17
Order Continuing Hearing on Return Date of Order	135, 141
Order of June 10, 1940, Granting Motion to Quash Order for Production of Records.....	151
Order Extending Time to Docket Record on Appeal	159
Petition for Production of Records.....	2
Exhibits to Petition:	
A—Letter dated March 31, 1938.....	9
B—Summons	10
C—Affidavit of Warner E. Williams.....	12

Index	Page
Statement of Points on Appeal (District Court)	160
Statement of Points on Appeal (Circuit Court of Appeals)	258
Testimony (Exhibits):	
For Petitioner:	
1—Corporation Income Tax Return of Chandis Securities Company for the Year 1929	240
For Respondent:	
A—Transcript of Record in the case of Marion Otis Chandler vs. Com- missioner of Internal Revenue, Board of Tax Appeals Docket No. 67468 (Circuit Court of Appeals No. 8262)	165
First Amended Petition.....	165
Answer to Amended Petition.....	173
Statement of Evidence.....	176
Exhibits for petitioner:	
1—Group of promissory notes showing cancel- lations	222
2—Stock certificates Nos. 30 to 37 inclusive, is- sued to various indi- viduals and dated Jan- uary 2, 1930.....	226

Index	Page
3—Balance sheet of Chandis Securities Company prepared by Horace E. Downing, dated December 31, 1929.....	229
4—Journal entries showing increase in capital stock	231
5—Stock certificates, Nos. 38 to 47, inclusive, issued to various individuals and dated May 7, 1930	237
Witnesses for petitioner:	
Downing, Horace E.	
—direct	177
—cross	196
—redirect	211
—recross	216
—redirect	217
—cross	219

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F. B. YOAKUM, Jr., Esq.,
1031 Rowan Building,
Los Angeles, California. [1*]

In the District Court of the United States, in and
for the Southern District of California
Central Division

No. Misc. M-4-Y

GEORGE D. MARTIN, as Internal Revenue Agent
in Charge for the Sixth United States Internal
Revenue Collection District of California,
Petitioner,

v.

CHANDIS SECURITIES COMPANY and H. E.
DOWNING, as Assistant Secretary of Chan-
dis Securities Company,
Respondents.

PETITION FOR PRODUCTION
OF RECORDS

To the Honorable Judges of the United States
District Court:

George D. Martin, as Internal Revenue Agent in
Charge of the Sixth Internal Revenue District of
California, by Ben Harrison, United States Attor-
ney for the Southern District of California, E. H.
Mitchell, Assistant United States Attorney for said
District, and Eugene Harpole, Special Attorney,
United States Bureau of Internal Revenue, his at-
torneys, respectfully shows to the Court:

I.

That this proceeding is commenced at the request
of the Attorney General of the United States and

is authorized and sanctioned by the United States Commissioner of Internal Revenue.

II.

That he, George D. Martin, is now and at all times since October 1, 1933, has been the United States Internal Revenue Agent [2] in Charge for the Bureau of Internal Revenue in the Sixth Internal Revenue Collection District of California, with his post of duty at Los Angeles, California, and as such Internal Revenue Agent in Charge, is designated to make examinations of tax returns required to be filed under the provisions of the Internal Revenue law. That he, the said Internal Revenue Agent in Charge, is required, with the assistance of Revenue Agents directly under his supervision, to examine books, records and other memoranda bearing upon any matter under investigation. That he is authorized to require the attendance before him of any person rendering a return or any other person having knowledge in the premises to give testimony concerning such matters and to produce and testify as to the contents of such records, papers and memoranda having a bearing upon such investigation as may be under his or their custody and control. A copy of the authorization of said George D. Martin is attached hereto as Exhibit "A".

III.

The said respondent, Chandis Securities Company, is a corporation duly organized and existing

under and by virtue of the laws of the State of California, with its principal place of business in the Times Building at First and Spring Streets in Los Angeles, California. The said respondent, H. E. Downing, is a resident of the City of Los Angeles, State of California, and the Assistant Secretary of said Chandis Securities Company and as such Assistant Secretary, is in charge of the records, papers and memoranda of said corporation. That Marian Otis Chandler is the Secretary of said Chandis Securities Company and the maker of an individual Federal income tax return for the year 1930, which return is now under investigation by your petitioner. That said respondents have under their control and in their custody certain records bearing upon the [3] matters required to be included in said tax return of Marian Otis Chandler for the year 1930.

IV.

On November 30, 1939, he, George D. Martin, pursuant to his duty and authorization as aforesaid, being engaged, through Revenue Agents Warner E. Williams and Lawrence W. Gibney directly under his supervision, in an investigation of the tax liability of Marian Otis Chandler for the year 1930, served upon said respondents a summons requiring respondents to appear before him, said George D. Martin, Internal Revenue Agent in Charge, as aforesaid, on the 11th day of December, 1939, at 10 o'clock in the forenoon at Room 1250, United States Post Office and Court House, Los

Angeles, California, to give testimony in the matter of the tax liability of the said Marian Otis Chandler for the year indicated heretofore and to bring with them the following books and papers:

Records of Chandis Securities Company for the years 1916 to 1930, inclusive, as follows: Minute books; capital stock certificate books, ledgers and journals; all accounting books and records including general ledgers, together with all vouchers, correspondence and other written data supporting the original entries in said accounting books; all promissory notes of Chandis Securities Company issued, assigned, endorsed, or otherwise transferred during said years to Marian Otis Chandler, Franceska Chandler Kirkpatrick, May Chandler Goodan, Helen Chandler, Philip Chandler, Ruth Chandler Williamson, Harrison Gray Chandler, Constance Chandler, and Norman Chandler which have been paid or otherwise cancelled. [4]

A copy of said summons is attached hereto and marked Exhibit "B". The said books, records and memoranda and said testimony of respondents being books, records, memoranda and testimony bearing and touching upon the investigation of the tax liability of said Marian Otis Chandler for the year 1930, the same being under investigation as aforesaid.

V.

On November 30, 1939, said summons was duly delivered to respondents by being physically handed

to respondent H. E. Downing, personally, by Revenue Agents Lawrence W. Gibney and Warner E. Williams.

VI.

Thereafter said respondents failed and refused to appear in answer to said summons and still continue in such failure and refusal, giving as their reasons therefor the matters set forth in the following letter:

“CHANDIS SECURITIES COMPANY

Times Building

Los Angeles, California

December 11, 1939

“Honorable George D. Martin,
Internal Revenue Agent in Charge,
Los Angeles, California.

In the Matter of the Tax Liability
of Marian Otis Chandler—Year 1930

“Dear Sir:

“Reference is made to your ‘Summons to Appear, to Testify and to Produce Books, etc.’ in the matter of Marian Otis Chandler for the year 1930, addressed to [5] Chandis Securities Company, H. E. Downing, Assistant Secretary, dated November 30, 1939, requiring appearance on December 11, 1939, of said Assistant Secretary, and the production of numerous books, accounts, records, etc. for the years 1916 to 1930, inclusive.

“The records that you now wish to examine, many of which are probably lost or destroyed, have been examined many times by your agents. We believe the provisions of the statute and the Constitution protect us against unreasonable searches or investigations and we respectfully suggest that the proposed search and investigation is unreasonable, unnecessary and oppressive. If we are correct in this conclusion it would follow that we are privileged to resist the subpoena. For your consideration we submit the correctness of our position.

“Assuring you of our desire at all times to cooperate with your agents in the examination of books and records, and also to comply with summons or subpoenas issued under legal authority, we are

Respectfully yours,

CHANDIS SECURITIES
COMPANY

(signed) H. E. DOWNING

Assistant Secretary”

VI.

Petitioner requests the aid of the Court in the premises, and, therefore, prays that an Order be issued requiring the said Chandis Securities Company and H. E. Downing, respondents as aforesaid, to appear before the said George D. Martin, Internal Revenue Agent in Charge, as aforesaid, at the office of the said Internal [6] Revenue Agent in

Charge, Room 1250 United States Post Office and Court House, Los Angeles, California, on the 11th day of March, 1940, at 10 o'clock in the forenoon and then and there produce said records and give said testimony as above referred to. This Petition is supported by the Affidavit of Warner E. Williams, hereto attached and marked Exhibit "C" and by reference made a part hereof, and the Memorandum of Points and Authorities appended as Exhibit "D".

GEORGE D. MARTIN,
Internal Revenue Agent in Charge.
BEN HARRISON,
United States Attorney,
E. N. MITCHELL,
Asst. U. S. Attorney,
EUGENE HARPOLE,
Special Attorney,
Bureau of Internal Revenue,
By EUGENE HARPOLE,
Attorneys for Petitioner.

State of California,
County of Los Angeles—ss.

George D. Martin, of full age, being duly sworn on his oath, says:

I am the Internal Revenue Agent in Charge in and for the Sixth Internal Revenue Collection District with my post of duty at Los Angeles, State of California. I have read the above Petition and

the matters and things therein contained are true to the best of my knowledge, information and belief.

GEORGE D. MARTIN

Subscribed and sworn to before me this 4th day of March, 1940.

[Seal]

JAMES F. SHEEHY,

Notary Public in and for the County of Los Angeles, State of California. [7]

EXHIBIT "A"

IT:F:FN

March 31, 1938

Mrs. Marian Otis Chandler,
Los Angeles, California.

Dear Madam:

While it is the policy of the Bureau to make as few inspections of books of account and records of taxpayers as possible, it is deemed necessary before finally closing your income tax case to make a re-investigation of your books and records for the year 1930 in order to properly verify your return for that year. A re-examination therefore will be made.

I am sure you will permit our representatives to have access to all of your books and records and that you will cooperate fully with them. I trust this will not cause you any inconvenience.

This notice is sent in compliance with Section 1105 of the Revenue Act of 1926.

Very truly yours,

(signed) MILTON E. CARTER

Acting Commissioner.

RN. [8]

EXHIBIT "B"

SUMMONS TO APPEAR, TO TESTIFY, AND
TO PRODUCE BOOKS, ETC.

In the matter of the tax liability of
MARIAN OTIS CHANDLER

District of 6th California, for the year 1930.

The Commissioner of Internal Revenue To Chandis
Securities Company, H. E. Downing, Assistant
Secretary, Residing at Los Angeles, California.

Greeting:

You are hereby summoned and required to appear before the undersigned Internal Revenue Agent in Charge, at Room 1250, U. S. Post Office and Court House, Los Angeles, California on the 11th day of December, 1939, at 10 o'clock in the forenoon, to give testimony in the matter of the tax liability of the above-named person for the year designated, and directed to bring with you the following books and papers:

Records of Chandis Securities Company for the years 1916 to 1930, inclusive, as follows: Minute books; capital stock certificate books, ledgers and journals; all accounting books and records including general ledgers, journals, cash books, other written data supporting the original entries in said accounting books; all promissory notes of Chandis Securities Company issued, assigned, endorsed, or otherwise transferred during said years to Marian Otis Chandler, Franceska Chandler Kirkpatrick, May Chandler Goodan, Helen Chandler, Philip

Chandler, Ruth Chandler Williamson, Harrison Gray Chandler, Constance Chandler, and Norman Chandler which have been paid or otherwise cancelled.

Failure to comply with this summons will render you liable to proceedings in the district court of the United States for the district in which you reside, to compel your attendance, testimony, and production of books, etc.

Witness my hand this 30th day of November, 1939.

(signed) GEORGE D. MARTIN

Internal Revenue Agent in Charge. [9]

Excerpts from the Internal Revenue Code.

Sec. 3614. The Commissioner, for the purpose of ascertaining the correctness of any return or for the purpose of making a return where none has been made, is hereby authorized, by any officer or employee of the Bureau of Internal Revenue, including the field service, designated by him for that purpose, to examine any books, papers, records, or memoranda bearing upon the matters required to be included in the return, and may require the attendance of the person rendering the return or of any officer or employee of such person, or the attendance of any other person having knowledge in the premises, and may take his testimony with reference to the matter required by law to be included in such return, with power to administer oaths to such person or persons.

Sec. 3633. (a) If any person is summoned under the internal-revenue laws to appear, to testify, or

to produce books, papers, or other data, the district court of the United States for the district in which such person resides shall have jurisdiction by appropriate process to compel such attendance, testimony, or production of books, papers, or other data.

EXHIBIT "C"

AFFIDAVIT

State of California

County of Los Angeles—ss.

Warner E. Williams, being duly sworn, deposes and states, as follows:

1. That he is employed as an Internal Revenue Agent by the Bureau of Internal Revenue, assigned to duty at Los Angeles, California, and has been so employed since the year 1923;

2. That he is familiar with the Federal income tax return filed by Marian Otis Chandler for the calendar year 1930, and the Government's attempt to determine why certain asserted interest income in excess of \$650,000.00 was not reported thereon;

3. That the asserted interest income at issue was received by Marian Otis Chandler from the Chandis Securities Company, a corporation;

4. That most of the facts in connection with the receipt of this asserted interest income, the manner of its accrual, and its value at the date of receipt for taxation purposes, are contained in the books and records of the Chandis Securities Company for the years 1916 to 1930, inclusive;

5. That one H. E. Downing, Assistant Secretary of the Chandis Securities Company, has unusual personal knowledge of said transactions;

6. That it is necessary that representatives of the Bureau of Internal Revenue examine the books and records of the Chandis Securities Company for the years 1916 to 1930, inclusive, and question said H. E. Downing, in order to determine whether Marian Otis Chandler committed a fraud against the Revenue by failing [10] to report upon the income tax return filed by her for the calendar year 1930 a large sum of asserted interest income received by her from the said Chandis Securities Company in the year 1930.

WARNER E. WILLIAMS

Subscribed and sworn to before me this 4 day of March, 1940.

[Seal]

JAMES F. SHEEHY

Notary Public in and for the County of Los Angeles, State of California.

* * * * *

[Endorsed]: Filed March 5, 1940. [11]

[Title of District Court and Cause.]

ORDER FOR PRODUCTION OF RECORDS

It appearing to the Court from the Petition of George D. Martin, by Ben Harrison, United States Attorney for the Southern District of California, E. H. Mitchell, Assistant United States Attorney for

the said District, and Eugene Harpole, Special Attorney, United States Bureau of Internal Revenue, his attorneys, that:

I.

George D. Martin is the Internal Revenue Agent in Charge for the Collection District of California, United States Bureau of Internal Revenue at Los Angeles and in the Sixth Internal Revenue District and is, as such, required to examine books, papers and other memoranda bearing upon any matter required to be included in any tax return required under the Internal Revenue Laws; that he as said Internal Revenue Agent in Charge has the income tax liability of Marian Otis Chandler for the year 1930 assigned to him for investigation; that in such investigations said Internal Revenue Agent in Charge is [26] authorized to require the attendance before him of any person rendering a return, or of any officer or employee of such person, or the attendance of any other person having knowledge in the premises and may take his testimony with reference to the matters required by law to be included in such return; and it further appearing that the respondents are persons having knowledge in the premises and as such have in their custody and under their control certain records which are necessary for examination for the purpose of determining the accuracy of the return of Marian Otis Chandler for the year 1930; and it further appearing that the said respondents are residents of the County and City of Los Angeles in the State of

California; and it further appearing that in pursuance of the statutes the said Internal Revenue Agent in Charge served upon the respondents a summons to appear before him and produce certain records and give testimony with reference to the matters required by law to be included in the return of the said Marian Otis Chandler, the records being more particularly described as follows:

“Records of Chandis Securities Company for the years 1916 to 1930, inclusive, as follows: Minute books; capital stock certificate books, ledgers and journals; all accounting books and records including general ledgers, journals, cash books, auxiliary registers and ledgers, together with all vouchers, correspondence and other written data supporting the original entries in said accounting books; all promissory notes of Chandis Securities Company issued, assigned, endorsed, or otherwise transferred during said years to Marian Otis Chandler, Franceska Chandler Kirkpatrick, May Chandler Goodan, Helen Chandler, Philip Chandler, Ruth Chandler Williamson, Harrison Gray Chandler, Constance Chandler, and Norman Chandler which have been paid or otherwise cancelled.” [27]

And it further appearing that the said respondents having ignored the said summons and having refused to appear before the said Internal Revenue Agent in Charge and testify concerning or to produce said books, records and papers of said respond-

ents and that the Government requests the aid of the Court in the premises,

It Is, Therefore, on this 5th day of March, 1940, Ordered that the said Chandis Securities Company and H. E. Downing, its Assistant Secretary appear before the said George D. Martin, Internal Revenue Agent in Charge, as aforesaid, at the office of said Internal Revenue Agent in Charge, Room 1250, United States Post Office and Court House, Los Angeles, California, on the 11th day of March, 1940, at 10 o'clock in the forenoon, and produce the above described records and give testimony with reference to those records and to the matters required by law to be included in the return of said Marian Otis Chandler for the year indicated.

Dated: This 5th day of March, 1940.

LEON R. YANKWICH

United States District Judge

[Endorsed]: Filed Mar. 5, 1940. [28]

[Title of District Court and Cause.]

ORDER CONTINUING RETURN DATE OF
ORDER FOR PRODUCTION OF RECORDS

Upon reading and filing the affidavit of T. B. Cosgrove, and good cause appearing therefor,

It is hereby Ordered that the return date upon the "Order for Production of Records" heretofore issued in the above mentioned cause be, and the same is hereby continued to Monday, March 20,

1940, at 10 o'clock A. M., in Room 1250 United States Post Office and Court House, Los Angeles, California; this order is without prejudice to the rights of respondents or either of them to move to quash said "Order for Production of Records", or otherwise oppose the same.

It is Further Ordered, that a copy of this Order, together with a copy of the affidavit in support of the request therefor, be served upon Eugene Harpole, Special Attorney, United States Bureau of Internal Revenue, on or before March 9, 1940.

Dated: March 9, 1940.

WM. P. JAMES

District Judge.

[Endorsed]: Filed Mar. 9, 1940. [30]

[Title of District Court and Cause.]

ORDER CONTINUING RETURN DATE OF
ORDER FOR PRODUCTION OF RECORDS

Petitioner, by his attorney, Eugene Harpole, Esq., and respondents, by their attorneys, T. B. Cosgrove, Esq. and F. B. Yoakum, Jr., Esq., having heretofore stipulated that the return date upon the Order for Production of Records heretofore issued might be continued to April 8, 1940, and good cause appearing therefor,

It Is Hereby Ordered that the return date upon said Order for Production of Records be, and the same is, hereby continued to April 8, 1940, at 10:00

o'clock, A. M., in Room 1250, United States Post Office and Court House, Los Angeles, California; this order is without prejudice to the rights of respondents, or either of them, to move to quash said Order for Production of Records or otherwise oppose the same.

Dated, March 15, 1940.

LEON R. YANKWICH

District Judge

Approved as to form as required by Rule 8.

BEN HARRISON,

U. S. Attorney

E. H. MITCHELL,

Assistant U. S. Attorney

EUGENE HARPOLE,

Special Attorney, U. S. Bureau of Internal Revenue,

By EUGENE HARPOLE

Attorneys for Petitioner

[Endorsed]: Filed March 15, 1940. [31]

[Title of District Court and Cause.]

NOTICE OF MOTION TO QUASH ORDER
FOR PRODUCTION OF RECORDS

To George D. Martin, as Internal Revenue Agent in Charge for the Sixth United States Internal Revenue Collection District of California, Petitioner; and Ben Harrison, United States Attorney, E. H. Mitchell, Assistant United States Attorney, and Eugene Harpole, Special Attorney, Bureau of Internal Revenue, Attorneys for Petitioner:

You and each of you will please take notice that on Monday, April 8, 1940, at 10 o'clock A. M., or as soon thereafter as counsel can be heard, Chandis Securities Company and H. E. Downing (individually and as Assistant Secretary of Chandis Securities Company) will move the above court, in the Court Room of Honorable Leon R. Yankwich, judge thereof, in the United States Post Office and Court House, with reference to the Order for Production of Records issued out of the above entitled court on March 5, 1940, for an order as follows:

1. Quashing and vacating said Order for Production of Records; [33]

2. Quashing and vacating said Order for Production of Records in so far as it seeks to compel production of each or any of the following records of Chandis Securities Company:

- (a) Minute Books;
- (b) Capital Stock Certificate Books;
- (c) Ledgers;

- (d) Journals;
- (e) Accounting Books;
- (f) Accounting Records;
- (g) General Ledgers;
- (h) Cash Books;
- (i) Auxiliary Registers;
- (j) Auxiliary Ledgers;
- (k) Vouchers supporting original entries in the above designated accounting books;
- (l) Correspondence supporting the original entries in the above designated accounting books;
- (m) Other written data supporting the original entries in the above designated accounting books;
- (n) Promissory notes of Chandis Securities Company issued or assigned or endorsed, or otherwise transferred, during the years 1916 to 1930, inclusive, to:

- (1) Marian Otis Chandler, or
- (2) Franceska Chandler Kirkpatrick, or
- (3) May Chandler Goodan, or
- (4) Helen Chandler, or
- (5) Philip Chandler, or
- (6) Ruth Chandler Williamson, or
- (7) Harrison Gray Chandler, or
- (8) Constance Chandler, or
- (9) Norman Chandler, [34]

which have been paid or otherwise cancelled;

3. For such other relief as may be proper.

Said motion will be made by the respondents, the

moving parties herein, jointly and severally, and by said H. E. Downing, both individually and in his capacity as Assistant Secretary of Chandis Securities Company, and will be made, severally and collectively, upon each of the following grounds:

1. Said Order is unreasonable and oppressive and the enforcement thereof would be an abuse of the process of the court.

2. Enforcement of said Order would subject said Chandis Securities Company to unnecessary examination and investigation in violation of the provisions of Section 3631 of the Internal Revenue Code.

3. Enforcement of said Order would constitute an unreasonable search and seizure of the property of Chandis Securities Company contrary to the provisions of the Fourth Amendment of the Constitution of the United States.

4. Enforcement of said Order would result in the taking of the property of Chandis Securities Company, namely, the books and records necessary to the orderly conduct of its business, without compensation and without due process of law, in violation of its rights, privileges and immunities under the Fifth Amendment of the Constitution of the United States.

5. The income tax return of said Marian Otis Chandler for the year 1930 was filed in good faith and within the time allowed by law; the income taxes assessed by reason of said return and any deficiency assessment for said year were duly settled

and paid; the time for further assessment and collection of such taxes for said year had expired by operation of law prior to the granting of the order herein sought to be vacated, unless said return was false or fraudulent with intent to evade tax; [35] there is no proof or prima facie showing that said return was false or fraudulent with intent to evade tax; there is no showing that said Marian Otis Chandler ever waived the limitation of time within which such further tax could be assessed.

6. Said order is oppressive and unlawful in that it requires the respondents and each of them to submit to repeated search and examination of themselves and their private files, records and property, without probable cause or reasonable necessity therefor being shown.

7. Compliance with said Order would not add to the information concerning the 1930 return of said Marian Otis Chandler which is already in the possession of or otherwise readily available for the use of the Commissioner of Internal Revenue.

8. It affirmatively appears from the files and records in this proceeding that there is no reasonable necessity or probable cause for a re-examination or re-investigation of the income tax liability of Marian Otis Chandler for the year 1930 because of the receipt of the alleged "interest income" referred to in the petition herein.

9. No one of the documents called for and which relates to a period prior to the year 1929 is shown

to be material or probably material to an investigation of the 1930 income tax return of Marian Otis Chandler.

10. It affirmatively appears that all records herein called for have already been subjected to examination by the Commissioner of Internal Revenue, his deputies and agents, in connection with the so-called "interest income" item referred to in the Petition, and further examination is unjustified, unlawful and oppressive unless some showing is made of fraud or reasonable ground for suspicion of fraud. [36]

11. The letter dated March 31, 1938 (Exhibit A to the Petition of said George D. Martin), does not constitute a good, sufficient or legal basis for the additional inspection, examination and investigation sought by the petitioner and required by the Order.

12. Said Order requires production of records not specified in the Petition, namely: Cash Books, Auxiliary Registers and Auxiliary Ledgers.

Said motion will be based upon this Notice of Motion, the affidavit of H. E. Downing attached hereto, the records and files of this cause, the points and authorities attached hereto, the transcript of record in that certain cause entitled "Commissioner of Internal Revenue vs. Marian Otis Chandler", being proceeding number 8262 in the files and records of the United States Circuit Court of Appeals for the Ninth Circuit, which said transcript (or a true copy thereof) will be offered in evidence at the

Securities Company for the years 1916 to 1930, inclusive, and bring with him the books, records and papers designated in Paragraph IV of the petition herein, a copy of said summons being attached hereto and marked "Exhibit 3".

That on December 11, 1939 a letter, bearing that date and addressed to said petitioner, was signed by affiant as Assistant Secretary of said Chandis Securities Company and was, as affiant is informed and believes, delivered to said petitioner on that date; that a copy of said letter is attached hereto and marked "Exhibit 4".

That neither affiant nor Chandis Securities Company has received any notice or has any knowledge or information to the effect that the petitioner has abandoned or intends to abandon his attempt to examine the books and records specified in the Court's order in connection with the tax liability of Chandis Securities Company for the years 1916 to 1930, inclusive.

That affiant on or about October 5, 1933 testified under oath in proceedings before the United States Board of Tax Appeals in the following named cases:

Name**Docket No.**

Mrs. Marian Otis Chandler	vs. Commissioner of Internal Revenue	67468
Ruth Chandler Williamson	vs. Commissioner of Internal Revenue	67469
Harrison Gray Chandler	vs. Commissioner of Internal Revenue	67470
Constance Chandler	vs. Commissioner of Internal Revenue	67471
May Chandler Goodan	vs. Commissioner of Internal Revenue	67472
Norman Chandler	vs. Commissioner of Internal Revenue	67473
Dr. John L. Kirkpatrick	vs. Commissioner of Internal Revenue	67474
Helen Chandler	vs. Commissioner of Internal Revenue	67475

[39]

Philip Chandler	vs. Commissioner of Internal Revenue	67476
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and the testimony given by affiant both on direct and cross examination in said proceedings related to the tax liability of the aforementioned taxpayers on account of the receipt by them of shares of stock of Chandis Securities Company issued in exchange for its notes, including accrued interest, held by them.

That the interest that had accrued, at the times hereinafter more particularly set out, on the notes of the Chandis Securities Company held by Marian Otis Chandler, amounted to \$661,369.56. Affiant believes and therefore states that this is the same item that is referred to as "asserted interest income" in the affidavit of Warner E. Williams filed in support of the petition in this proceeding. That there were no payments or credits of interest made by Chandis Securities Company to Mrs. Marian Otis Chandler during the year 1930, except in the manner herein outlined.

That in the "Statement of Recomputation" of the tax liability of Marian Otis Chandler for the year 1929, submitted by the Commissioner of Internal Revenue to the Board of Tax Appeals pursuant to its opinion rendered therein, and hereinafter more particularly referred to, the Commissioner made the following statement:

"In accordance with the decision of the United States Board of Tax Appeals the petitioner did not realize any taxable income in 1929 in connection with the transaction whereby she received stock of Chandis Securities Com-

pany, Los Angeles, California, in payment of a promissory note of that corporation amounting to \$810,687.06 and accrued interest thereon in the amount of \$661,369.56. Accordingly, the amount of \$661,369.56 has been eliminated from the net income, disclosed by the sixty-day letter."

Affiant further states that this is the only item of interest "in excess of \$650,000," that was ever owed by Chandis Securities Company to Marian Otis Chandler. Affiant further states that of the total sum of \$661,369.56 the amount of \$294,950.76 represented interest accrued to December 31, 1923 on notes of Chandis Securities Company held by Marian Otis Chandler; that on December 31, 1923 new notes were issued for the old notes and accrued interest; that the interest which accrued on the renewal [40] notes from January 1, 1924 to December 31, 1929 was \$366,418.80, developing a total of \$661,369.56, the amount referred to in the petition as "in excess of \$650,000."

That the facts relating to the aforementioned exchange of notes and accrued interest for stock of Chandis Securities Company (except the time of the receipt of said stock by the aforementioned taxpayers) were stipulated by the respective counsel for the Commissioner and the taxpayers and were submitted to and accepted by the Board of Tax Appeals in the foregoing proceedings, a copy of said stipulation being attached hereto and marked "Exhibit 5".

That the Board of Tax Appeals under date of June 7, 1935 promulgated its opinion, a copy of which is attached hereto and marked "Exhibit 6", wherein the Board of Tax Appeals held that the aforementioned taxpayers received the stock of Chandis Securities Company for said notes and interest during the year 1930.

That appeals from the decisions of the Board of Tax Appeals in the above entitled cases were taken to the Circuit Court of Appeals for the Ninth Circuit, and the case of Marian Otis Chandler was selected as a test case, the others having been held in abeyance, that said case of Marian Otis Chandler was entitled "Commissioner of Internal Revenue, Petitioner, v. Marian Otis Chandler, Respondent, No. 8262"; and the Circuit Court of Appeals, in a decision dated April 12, 1937 and reported in 89 Fed. (2d) 332, affirmed the decision of the Board of Tax Appeals.

That in the proceedings before the United States Board of Tax Appeals in behalf of Marian Otis Chandler and the other taxpayers above mentioned there were submitted by stipulation true copies of the minutes of the board of directors of Chandis Securities Company having to do with the adoption and consummation of the plan of reorganization of Chandis Securities Company and the exchange, pursuant to that plan, of stock of Chandis Securities Company for its notes held by the aforementioned individuals.

That in the said proceedings before the United States Board of Tax Appeals there was offered and

received in evidence the stock certificate book of Chandis Securities Company, which after having been identified and received, was withdrawn and photostatic copies of the stubs and certificates, both front and back, were substituted, and copies of said photostats given to the Commissioner's representative.

That there were also offered and received in evidence in said proceedings [41] before the United States Board of Tax Appeals the notes of Chandis Securities Company held by the aforementioned individuals and exchanged in 1930 for its stock; and these notes, after having been identified and received, were, with the consent of Commissioner's counsel, withdrawn and photostatic copies substituted and copies of said photostats were given to the Commissioner's representative.

That there were also offered and received in evidence the original book entries of Chandis Securities Company relating to the issuance of stock for the notes; these original entries, after having been identified and received, were withdrawn and photostatic copies submitted to the Board, and copies thereof given to the Commissioner's counsel.

That within four months after rendering its opinion in the case of Marian Otis Chandler, et al., for the year 1929, and on October 3, 1935, the Board of Tax Appeals rendered an opinion in the case of Daniel H. Burnham v. Commissioner, 33 B. T. A. 147, to the effect that the issuance of stock for notes and accrued interest was a tax-free reorganization

within the meaning of Section 112 (b) (3) of the Revenue Act of 1928 and that the note holder did not derive taxable income when he received the stock. In the Burnham case the taxpayer, as affiant is informed and believes, was claiming a loss on account of the exchange and the Commissioner made the contention that the issuance of new stock for notes and accrued interest was merely a reorganization and therefore resulted in neither taxable gain nor deductible loss.

That an appeal from the Board's decision in the Burnham case was taken to the Circuit Court of Appeals for the Seventh Circuit, 86 Fed. (2d) 776, and that court affirmed the decision of the Board of Tax Appeals.

That a petition for a writ of certiorari was filed in the Burnham case, but was denied by the Supreme Court of the United States on April 5, 1937, 300 U. S. 683.

That the Commissioner of Internal Revenue in Cumulative Bulletin 1937-2, page 281, July to December Rulings, Ct. D. No. 1245, published his acquiescence in the decision in the Burnham case, and thereby accepted and adopted said decision as the correct interpretation and construction of the law.

That attached hereto, marked "Exhibit 7", is a true copy of the findings of fact and opinion of the United States Board of Tax Appeals in the case of Marian Otis Chandler, 16 B. T. A. 1248, which findings and opinion relate, in part, to the [42] "as-

served interest income" item mentioned in "Exhibit C" attached to the petition in this proceeding.

That the Commissioner of Internal Revenue, acting through his agents, has made an examination of the income tax returns of Chandis Securities Company for each of the years 1916 to 1930, inclusive, and the time for making additional assessments against Chandis Securities Company for any of these years has long since expired.

That during the year 1924 the Commissioner of Internal Revenue, through his agents, made an extended, exhaustive and studious examination and analysis of the records of Chandis Securities Company for the calendar years 1919 to 1923, inclusive, the result of such examination being recorded in a Revenue Agent's report dated December 9, 1924.

That during the year 1929 the Commissioner of Internal Revenue, through his agents, made an extended, exhaustive and studious examination and analysis of the records of Chandis Securities Company for the years 1924 to 1927, inclusive, the result of such examination being recorded in a Revenue Agent's report dated September 24, 1929; that a similar examination was made for the year 1928 and a Revenue Agent's report was likewise made, but affiant does not have the date of said report; that with respect to the years 1929 and 1930 Chandis Securities Company was advised by the internal revenue agent in charge thereof that its returns for said years would be recommended for acceptance by the Commissioner of Internal Revenue as

correct; and that no notice of any action contrary to such recommendation has ever been received by said Chandis Securities Company.

That at the time of the proceedings before the United States Board of Tax Appeals for and on behalf of Mrs. Marian Otis Chandler and the other taxpayers named, for the year 1929, all the records of Chandis Securities Company relating or in any way pertinent to the determination of the taxability of the "asserted interest income" item referred to in the affidavit of Warner E. Williams were exhibited to and examined by the Commissioner's representatives; that in addition thereto the petitioner has in his possession and/or there are available to him for examination the findings of fact established by the Board of Tax Appeals, the records and decisions of the Board of Tax Appeals and the transcript of record of the United States Circuit Court of Appeals for the Ninth Circuit in that certain proceeding entitled "Commissioner of Internal [43] Revenue, Petitioner, v. Marian Otis Chandler, Respondent, No. 8262."

That said records and data now in the possession of said petitioner or available to him constitute complete and true copies and/or explanations of all items of record of said Chandis Securities Company referring or relating to, or in any manner pertinent to the tax liability of Marian Otis Chandler for the year 1930 as hereinbefore more specifically described.

That all of the facts and figures which the records

of said Chandis Securities Company disclose and which are pertinent or relative to, or which may be used to determine, the income tax liability of Marian Otis Chandler for the year 1930 on account of the "asserted interest income" item referred to in the affidavit of Warner E. Williams attached to said petition as "Exhibit C", or "to determine whether said Marian Otis Chandler committed a fraud against the Revenue by failing to report upon the income tax return filed by her for the calendar year 1930" the "asserted interest income" referred to in said "Exhibit C", have already been disclosed and made available to the Commissioner of Internal Revenue, and affiant is informed and believes and on such information and belief states that such facts and figures are already in the possession of or available to the petitioner.

That the income tax return of Marian Otis Chandler for the year 1930 was filed with the Collector of Internal Revenue on or about the 15th day of March, 1931 and the tax thereon shown to be due was paid in the manner provided by law; that thereafter the Commissioner of Internal Revenue made an examination of said return and proposed additional taxes in the sum of \$603.68; that under date of January 28, 1933 said Marian Otis Chandler executed a waiver on Treasury Department Form 870 waiving her right to file a petition with the United States Board of Tax Appeals under section 274 (a) of the Revenue Act of 1926 and Section 272 (a) of the Revenue Act of 1928, and con-

sented to the assessment and collection of the said deficiency; that thereafter said additional taxes were duly paid; that affiant is informed and believes and therefore states that at no time has the Commissioner of Internal Revenue made any other assessment of additional tax for the year 1930; that at no time has Marian Otis Chandler, by waiver or otherwise, extended the time within which the Commissioner may make an additional assessment of tax; affiant further states upon information and belief that the Commissioner of Internal Revenue has not since [44] January 28, 1933 issued any letter of final determination proposing additional tax against Marian Otis Chandler for the year 1930, and that no appeal has ever been filed by Marian Otis Chandler with the United States Board of Tax Appeals for said year; that the time within which an assessment of additional tax may be made against Marian Otis Chandler for the year 1930, in the absence of fraud, has long since expired.

That prior to any action taken by Chandis Securities Company with respect to increasing its capital stock and issuing such stock for said notes and accrued interest, as hereinabove referred to, affiant consulted with income tax advisors, of recognized professional standing and ability, with respect to the said proposed transaction; that affiant was informed by said income tax advisors and believed that such transaction would be one in which neither gain nor loss would result either to Chandis Securities Company or the persons to whom said stock was

to be issued; that the income tax return of Marian Otis Chandler for the year 1930, which was prepared under the supervision of affiant, was full, true and correct and was made in good faith, and that the same was in no sense false or fraudulent with intent to evade tax.

Affiant is informed and believes and therefore states that Marian Otis Chandler is the only one of the taxpayers mentioned in the appeals to the United States Board of Tax Appeals hereinbefore referred to, relating to the year 1929, to whom the Commissioner of Internal Revenue has sent a letter indicating a desire to make a further examination for the year 1930.

That the Commissioner of Internal Revenue in his letter of final determination of the tax liability of Mrs. Marian Otis Chandler for the year 1929 did not charge her with fraud because of her failure to include in her income tax return for that year the "asserted interest income" item of \$661,369.56, which is the same item petitioner infers is taxable income for the year 1930; neither did the Commissioner before the Board of Tax Appeals in the aforementioned proceedings attempt to charge Mrs. Chandler with fraud because of her failure to report as taxable income the "asserted interest income" item of \$661,369.56; that attached hereto and marked "Exhibit 8" is a true copy of the Commissioner's letter of final determination dated July 1, 1932, sent to Marian Otis Chandler and relating to the year 1929, and [45] which letter formed the

basis of her appeal to the United States Board of Tax Appeals in her case above mentioned.

H. E. DOWNING.

Subscribed and sworn to before me this 19 day of March, 1940.

(Seal)

C. O. DENNING,
Notary Public in and for
said County and State.

[46]

“EXHIBIT 1”

Treasury Department
Washington

Office of
Commissioner of Internal Revenue

June 15, 1937

Address reply to
Commissioner of Internal Revenue
and refer to
IT:F:FN

Chandis Securities Company,
100 North Broadway,
Los Angeles, California.

Dear Sirs:

While it is the policy of the Bureau to make as few inspections of books of account and records of taxpayers as possible, it is deemed necessary before finally closing your case to make a reinvestigation of your books and records for the years 1916 to

1930, inclusive, in order to properly verify your returns for those years. A reexamination therefore will be made.

I am sure you will permit our representatives to have access to all of your books and records and that you will cooperate fully with them. I trust this will not cause you any inconvenience.

This notice is sent in compliance with Section 1105 of the Revenue Act of 1926.

Very truly yours,

(signed) GUY T. HELVERING,

Commissioner. [47]

“EXHIBIT 2”

Los Angeles, California

November 28, 1939

Commissioner of Internal Revenue,
Washington, D. C.

In re: Chandis Securities Company

Years 1916 to 1930

Your File IF:F:FN

Dear Sir:

Your letter of June 15, 1937 was served upon the undersigned on or about November 10, 1939.

In this letter you state that “it is deemed necessary before finally closing your case to make a reinvestigation of your books and records for the years 1916 to 1930 inclusive.” Inasmuch as we have no knowledge of any pending case we do not know

what "case" you are referring to, hence, we are unable to understand the necessity for a reinvestigation. Particularly is this so since our returns for the years involved have long since been examined and found correct, except in a few instances where additional taxes or overassessments were found. These have long since been paid and the years closed. What necessity now exists for a reinvestigation of accounts beginning almost a quarter of a century back is impossible for us to comprehend. We believe it the intention of the statute and the Constitution to protect citizens against unreasonable searches or investigations. We are unable to conceive of a more unreasonable search than one going back so many years and covering such a long period of time.

It has always been the policy of the officers of this company to give the utmost consideration and cooperation to your examining agents and we hope to continue that policy, but, under the circumstances, we feel it our privilege to deny you the right to make such an examination. We, therefore, request that you withdraw your letter of June 15, 1937.

Very truly yours,

CHANDIS SECURITIES
COMPANY

By H. E. DOWNING (Signed)
Assistant Secretary H. E. D. [48]

“EXHIBIT 3”

Form 860

Treasury Department

Internal Revenue Service

Rev. April, 1929

SUMMONS TO APPEAR, TO TESTIFY,
AND TO PRODUCE BOOKS, ETC.

In the matter of the tax liability of CHANDIS
SECURITIES COMPANY, District of 6th
California, for the years 1916 to 1930, inclu-
sive.

The Commissioner of Internal Revenue

To Chandis Securities Company

H. E. Downing, Assistant Secretary

Residing at Los Angeles, California

Greeting:

You are hereby summoned and required to ap-
pear before the undersigned Internal Revenue
Agent in Charge, at Room 1250, U. S. Post Office
and Court House, Los Angeles, California, on the
11th day of December, 1939, at 10 o'clock in the
forenoon, to give testimony in the matter of the
tax liability of the above-named person for the
years designated, and directed to bring with you
the following books and papers:

Records of Chandis Securities Company for the
years 1916 to 1930, inclusive, as follows:

Minute books; capital stock certificate books,
ledgers and journals; all accounting books and rec-
ords including general ledgers, journals, cash books,
auxiliary registers and ledgers, together with all

vouchers, correspondence and other written data supporting the original entries in said accounting books; all promissory notes of Chandis Securities Company issued, assigned, endorsed, or otherwise transferred during said years to Marian Otis Chandler, Franceska Chandler Kirkpatrick, May Chandler Goodan, [49] Helen Chandler, Philip Chandler, Ruth Chandler Williamson, Harrison Gray Chandler, Constance Chandler, and Norman Chandler which have been paid or otherwise cancelled.

Failure to comply with this summons will render you liable to proceedings in the district court of the United States for the district in which you reside, to compel your attendance, testimony, and production of books, etc.

Witness my hand this 30th day of November, 1939.

(signed) GEORGE E. MARTIN,
Internal Revenue Agent in Charge. [50]

“EXHIBIT 4”

December 11, 1939.

Honorable George D. Martin,
Internal Revenue Agent in Charge,
Los Angeles, California

Dear Sir:

In the Matter of Chandis Securities Company
Years 1916 to 1930, Inclusive.

Reference is made to your “Summons to Appear, to Testify and to Produce Books, etc.” in the mat-

ter of Chandis Securities Company for the years 1916 to 1930, inclusive, addressed to Chandis Securities Company, H. E. Downing, Assistant Secretary, dated November 30, 1939, requiring appearance on December 11, 1939 of said Assistant Secretary, and the production of numerous books, accounts, records, etc.

The records that you now wish to examine, many of which are probably lost or destroyed, have been examined many times by your agents, and the cases for the years involved have long since been closed. We believe the provisions of the statute and the Constitution protect us against unreasonable searches or investigations and we respectfully suggest that the proposed search and investigation is unreasonable, unnecessary and oppressive. If we are correct in this conclusion it would follow that we are privileged to resist the subpoena. For your consideration we submit the correctness of our position.

Assuring you of our desire at all times to cooperate with your agents in the examination of books and records, and also to comply with summons or subpoenas issued under legal authority, we are

Respectfully yours,

CHANDIS SECURITIES
COMPANY

H. E. DOWNING (Signed)

Assistant Secretary [51]

“EXHIBIT 5”

STIPULATION

1. It is hereby stipulated and agreed by and between the parties hereto by their respective counsel that the above entitled appeals may be consolidated for hearing and decision. [61]

2. It is further stipulated and agreed by and between the above-named parties through their respective counsel, that the following facts may be taken as true, subject to the right, however, of either party to produce at the time of hearing further and additional evidence not in conflict therewith.

3. That Petitioners are residents of the City of Los Angeles, California and as such filed their income tax returns for the year 1929 with the Collector of Internal Revenue for the Sixth Collection District, State of California.

4. That the books of account of each Petitioner have at all times been kept upon the cash receipts and disbursements basis, and the income tax return of each of the Petitioners was prepared and filed on said basis.

5. That the Chandis Securities Co. was incorporated during the year 1916 with an authorized capital stock of \$500,000.00 divided into 500 shares of a par value of \$1000 per share.

6. That at the time of its organization or shortly thereafter the Chandis Securities Co., in exchange for properties acquired by it, issued its promissory notes aggregating in principal the total sum of

\$1,938,548.60. That, until the said notes were cancelled as hereinafter set forth, each of the Petitioners held and owned notes aggregating in principal the amount set opposite their respective names as follows:

	Note principal
Marian Otis Chandler.....	\$ 810,687.06
Franceska Chandler Kirkpatrick.....	179,490.04
	[52]
May Chandler Goodan.....	179,490.04
Helen Chandler	130,474.68
Philip Chandler	130,474.68
Ruth Chandler Williamson.....	130,474.69
Harrison Gray Chandler.....	130,474.68
Constance Chandler	130,474.70
Norman Chandler	116,508.03
	<hr/>
Total.....	\$1,938,548.60
	<hr/>
	[62]

7. That the interest that accrued on said notes to and including December 31, 1923 amounted to the sums set opposite the names of Petitioners as follows:

	Accrued interest to December 31, 1923
Marian Otis Chandler.....	\$ 294,950.76
Franceska Chandler Kirkpatrick.....	66,533.84
May Chandler Goodan.....	66,533.83
Helen Chandler	45,648.37
Philip Chandler	45,648.36
Ruth Chandler Williamson.....	45,648.36
Harrison Gray Chandler.....	45,648.36
Constance Chandler	45,648.37
Norman Chandler	45,789.36
	<hr/>
Total.....	\$ 702,049.61
	<hr/>

8. That on December 31, 1923 the Chandis Securities Co. issued new notes for the foregoing notes and accrued interest to the Petitioners as follows:

Marian Otis Chandler.....	\$1,105,637.82
Franceska Chandler Kirkpatrick.....	246,023.88
May Chandler Goodan.....	246,023.87
Helen Chandler	176,123.05
[53]	
Philip Chandler	176,123.04
Ruth Chandler Williamson.....	176,123.05
Harrison Gray Chandler.....	176,123.04
Norman Chandler	162,297.39
<hr/>	
Total.....	<u><u>\$2,640,598.21</u></u>

9. That the amount of interest that accrued to Petitioners on their notes of the Chandis Securities Co. from January 1, 1924 to and including December 31, 1929, was as follows:

	Accrued Interest to Dec. 31, 1929
Marian Otis Chandler.....	\$ 366,418.80
Franceska Chandler Kirkpatrick.....	81,991.18
[63]	
May Chandler Goodan.....	81,991.18
Helen Chandler	58,218.25
Philip Chandler	58,218.26
Ruth Chandler Williamson.....	58,218.26
Harrison Chandler	58,218.26
Norman Chandler	53,516.22
Constance Chandler	58,218.26
<hr/>	
Total.....	<u><u>\$ 875,008.67</u></u>

10. That attached hereto and marked Exhibit "A" is a true copy of the minutes of meeting of the Board of Directors of Chandis Securities Co.

held at 10:00 A. M. on Monday, the 14th day of October, 1929. Pursuant to the resolution contained in said minutes the Chandis Securities Co. on October 14, 1929 filed its certificate with the duly constituted authorities of the State of California increasing its capitalization in the manner authorized in said resolution. [54]

11. That attached hereto and marked Exhibit "B" is a true copy of the minutes of meeting of the Board of Directors of Chandis Securities Co. held at the hour of 10:00 A. M. on the 18th day of December 1929; that on December 20, 1929 Chandis Securities Co. filed an application with the Corporation Commissioner of the State of California, copy of which is attached hereto and marked Exhibit "C"; that attached hereto and marked Exhibit "D" is a copy of a permit issued by the Corporation Commissioner of the State of California pursuant to the said application of Chandis Securities Co., which permit is dated December 26, 1929; that attached hereto and marked Exhibit "E" is a copy of an application of the Chandis Securities Company to the Corporation Commissioner of the State of California; that pursuant to said application the Corporation Commissioner issued its permit dated May 7, 1930, copy of which [64] is attached hereto and marked Exhibit "F".

12. The following is a table showing the shareholdings of the new stock and consideration therefor: [55]

Name	Notes and Interest to Dec. 31, 1929	Shares in exchange for notes and interest	Cash for frac- tional share	Total	Issue of stock for stock	Total shares out- standing
Marian Otis Chandler	\$1,472,056.62	14,720	\$43.38	14,721	2,000	16,721
Franceska Chandler Kirkpatrick	328,015.06	3,280	84.94	3,281	350	3,631
Mary Chandler Goodan	328,015.05	3,280	84.95	3,281	350	3,631
Helen Chandler	234,341.30	2,343	58.70	2,344	350	2,694
Philip Chandler	234,341.30	2,343	58.70	2,344	350	2,694
Ruth Chandler Williamson	234,341.31	2,343	58.69	2,344	350	2,694
Harrison Gray Chandler	234,341.30	2,343	58.70	2,344	350	2,694
Constance Chandler	234,341.33	2,343	58.67	2,344	350	2,694
Norman Chandler	215,813.61	2,158	86.39	2,159	350	2,509
Harry Chandler					200	200
	\$3,515,606.88	35,153	593.12	35,162	5,000	40,162

A. CALDER MACKAY,
Attorney for Petitioners

GEORGE M. THOMPSON,
JOHN T. RILEY,
Counsel for Petitioners.
E. BARRETT PRETTYMAN,
M. B. L.
Attorney for Respondent. (65)

“EXHIBIT 6”

United States Board of Tax Appeals

Docket No. 67468

MRS. MARIAN OTIS CHANDLER,
Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

Docket No. 67469

RUTH CHANDLER WILLIAMSON,
Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

Docket No. 67470

HARRISON GRAY CHANDLER,
Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

Docket No. 67471

CONSTANCE CHANDLER,
Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

Docket No. 67472

MAY CHANDLER GOODAN,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

Docket No. 67473

NORMAN CHANDLER,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

Docket No. 67474

DR. JOHN L. KIRKPATRICK,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

Docket No. 67475

HELEN CHANDLER,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

Docket No. 67476

PHILIP CHANDLER,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent. [92]

OPINION

Van Fossan: These proceedings were brought to redetermine deficiencies in the income taxes of the petitioners for the year 1929 in the following amounts:

Petitioner	Docket No.	Deficiency
Marian Otis Chandler.....	67468	\$163,175.03
Ruth Chandler Williamson.....	67469	24,466.69
Harrison Gray Chandler.....	67470	17,915.53
Constance Chandler	67471	17,515.10
May Chandler Goodan.....	67472	29,620.90
Norman Chandler	67473	19,235.24
John L. Kirkpatrick.....	67474	28,721.39
Helen Chandler	67475	17,522.91
Philip Chandler	67476	17,587.26

Two issues are presented:

(1) Was the transaction by which petitioners exchanged certain notes and interest for stock consummated in 1929 or 1930? (42)

(2) Did the petitioners realize taxable income by reason of such exchange?

The facts were stipulated in part and in part adduced by testimony.

In 1916 Harry Chandler incorporated the Chandis Securities Co., hereinafter called the company,

with a capital stock of 500 shares of the par value of \$1,000 per share, for which stock he transferred to it certain real and personal property. He transferred 200 of such shares to his wife, Marian Otis Chandler, and 280 shares thereof to his children, all of whom are petitioners. Later he transferred other properties to the company for its promissory notes, which he assigned to his wife and children in approxi- [93] mately the same proportion as their stockholdings. The notes so assigned and interest accrued to December 31, 1923, were in the following amounts:

	Note principal	Accrued interest to Dec. 31, 1923.
Marian Otis Chandler.....	\$810,687.06	\$294,950.76
Franceska Chandler		
Kirkpatrick	179,490.04	66,533.84
May Chandler Goodan.....	179,490.04	66,533.83
Helen Chandler	130,474.68	45,648.37
Philip Chandler	130,474.68	45,648.36
Ruth Chandler Williamson.....	130,474.69	45,648.36
Harrison Gray Chandler.....	130,474.68	45,648.36
Constance Chandler	130,474.70	45,648.37
Norman Chandler	116,508.03	45,789.36
	<hr/>	<hr/>
Total.....	1,938,548.60	702,049.61

On December 31, 1923, the Chandis Securities Co. issued new notes for the foregoing notes and accrued interest to the petitioners, which notes and interest accrued to December 31, 1929, were as follows:

	Note principal	Accrued interest to Dec. 31, 1929
Marian Otis Chandler.....	\$1,105,637.82	\$366,418.80
Franceska Chandler Kirkpatrick	246,023.88	81,991.18
May Chandler Goodan.....	246,023.87	81,991.18
Helen Chandler	176,123.05	58,218.25
Philip Chandler	176,123.04	58,218.26
Ruth Chandler Williamson.....	176,123.05	58,218.26
Harrison Gray Chandler.....	176,123.04	58,218.26
Constance Chandler	176,123.07	58,218.26
Norman Chandler	162,297.39	53,516.22
<hr/>		<hr/>
Total.....	2,640,598.21	875,008.67

[94]

On October 14, 1929, the board of directors of the company passed a resolution increasing its capital stock from 500 shares of the par value \$1,000 per share to 50,000 shares of the par value of \$100 per share and, pursuant thereto, filed the certificate reciting such action, as required by the state statute. (43)

On December 18, 1929, the board of directors of the company passed a resolution authorizing the company's officers to apply to the Corporation Commissioner of the State of California for permission to sell or issue 40,000 shares of its capital stock at par to liquidate the indebtedness of the company to its stockholders represented by the above notes. The resolution contained the following recitals and provisions:

Whereas, Chandis Securities Company is indebted to the following named persons, to-wit:

Marian Otis Chandler
Franceska C. Kirkpatrick
May O. Goodan
Helen Chandler
Philip Chandler
Ruth C. Williamson
Harrison G. Chandler
Constance Chandler
Norman Chandler

in the aggregate principal sum of \$2,640,598.21 all of which is evidenced by several promissory notes of this company held by said persons, dated December 31st, 1933, due on or before the 31st day of December, 1928, which notes bear interest at the rate of 5% per annum, compounded annually, on which no part of said principal or accrued interest has been paid, and

Whereas, the aforesaid persons have expressed their willingness and have offered to accept stock in this corporation at full par value thereof in full or part payment of their respective notes together with interest thereon.

Now, Therefore, be it resolved that, subject to the approval of [95] the Commissioner of Corporations of the State of California, this corporation issue to any and/or all of the aforesaid persons in liquidation and payment of all or part of the indebtedness as aforesaid, together with interest thereon accrued to the time of the issuance, fully paid stock in this corporation at its par value for the amount of the indebtedness so liquidated and paid, and that this corporation take and receive from the

persons aforesaid a cancellation and satisfaction of said notes to the extent that stock may be so issued to the respective holders thereof.

And Be It Further Resolved, That the President and Secretary of this Corporation be and they are hereby, authorized and empowered to make application to the Commissioner of Corporations of the State of California, for a permit to sell and/or issue to and/or among the foregoing persons only, and one other, forty thousand shares of the capital stock of this corporation, at par, either

(a) For cash, lawful money of the U. S., and/or

(b) Such amount thereof as may be necessary to pay, liquidate and discharge not to exceed the amount of the indebtedness to said persons, hereinbefore referred to, for principal and/or interest accrued on said notes to the time when said stock may be issued.

On December 20, 1929, the company filed such application, which was granted on December 26, 1929. The permit contained the following provision:

1. To issue to any and all of the persons named in its application filed on the 20th day of December, 1929, an aggregate of not to exceed 35,156 shares of its (44) capital stock as consideration for the cancellation of the indebtedness of applicant to them, described in said application; \$100.00 of such indebtedness to be canceled upon the issuance of each of said shares.

By its terms the permit expired December 26, 1931.

A table showing the stockholdings of the taxpayers and consideration therefor was incorporated in the stipulation. [96]

On January 2, 1930, the petitioners surrendered their notes in exchange for the stock certificates issued by the company that day and the notes thereupon were canceled. The certificates were actually delivered in May 1930. The canceled notes each bear on the face a receipt signed by the respective former holder as follows: "January 2, 1930. The receipt of capital stock of Chandis Securities Company in full settlement of principal and accrued interest to December 31, 1929 is hereby acknowledged."

From 1924 to 1929 the company accrued interest on the above described notes at 5 percent per annum and deducted such interest on its income tax returns. The company kept its books and made its income tax returns on the accrual basis, while each petitioner kept his books and filed his returns on the cash receipts and disbursements basis. The individuals did not report any interest received in connection with the above notes.

The notes in question were in the custody of Horace Downing, secretary of the company, throughout the year 1929. The balance sheet of the company on December 31, 1929, lists the notes of the petitioners among its liabilities. The books of the company contain appropriate entries to show that the transactions were consummated in 1930. It was stipulated that the value of the stock of the

company was \$60 per share at any time material to these proceedings.

If it be decided that the transaction of exchange was consummated in 1930, such determination disposes of the cases. There would be no need to consider the second issue. On the facts found above we are of the opinion that petitioners' contention that the exchange was made in 1930 is well taken.

The record discloses that on December 18, 1929, the petitioners, as owners of the above described notes issued on December 31, 1923, expressed their willingness to exchange them for stock in the company in proportion to the respective amounts of such notes and unpaid interest thereon. The company thereupon proceeded to apply for permission to issue the additional [97] capital stock required to accomplish the exchange. Such a permit was a prerequisite to the contemplated exchange and an issuance without such permit would have been void. See section 12 of the Corporate Securities Act, California. On December 26, 1929, the commissioner of corporation issued his permit authorizing the company to issue to the taxpayers: (45)

An aggregate of not to exceed 35,156 shares of its capital stock as consideration for the cancellation of the indebtedness of applicant to them, described in said application; \$100.00 of such indebtedness to be cancelled upon the issuance of each of said shares.

The permit thus required that the exchange should involve simultaneous cancellation of the notes and

issue of stock—that the cancellation and issuance were to coincide in time. The company had no right to issue and hence, the petitioners had no right to acquire, the new stock until the notes were surrendered and canceled. The acts were mutually dependent and the transaction which is asserted to be the source of income could not have been completed without both acts.

The record discloses that the petitioners' notes were surrendered and canceled on January 2, 1930, and the stock certificates were issued on that day or later in that month, but as of January 2, 1930. They were delivered in May, 1930. In this situation we are of the opinion that the exchange took place in 1930 and that, therefore, the taxpayers could not have received any income from the exchange of their notes for stock before January 2, 1930. In support of this conclusion it appears that the company's books reflect the continued ownership of the notes by the petitioners through December 31, 1929, and the consummation of the exchange in 1930.

The conclusion reached above disposes of the cases and requires a finding for the petitioners. We need not inquire whether taxpayers received income in 1930 as a result of the exchange.

Reviewed by the Board. [98]

EXHIBIT "7"

Docket No. 16259.

MARIAN OTIS CHANDLER,

Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

Promulgated June 29, 1929.

16 B. T. A., at P. 1248.

FINDINGS OF FACT.

In 1916 the husband of this petitioner incorporated the Chandis Securities Co. and transferred to it real and personal property in exchange for all of its capital stock—500 shares. Soon thereafter Chandler transferred 200 shares of this stock to his wife and 280 shares to their children. From time to time thereafter Chandler transferred other properties to the company, taking the company's promissory notes in payment; these notes Chandler assigned to his wife and children in approximately the same proportions as their stock holdings. The notes bore interest at 5 per cent per annum, but no interest was paid prior to or during the taxable years, nor was any fund set aside for such interest payments. During the taxable years the amounts of annual interest accrued upon these notes were as follows:

Holders of notes	1920	1921	1922	1923
Mrs. Chandler				
(petitioner)	\$48,384.36	\$50,803.58	\$53,343.76	\$56,116.13
Children	60,003.67	63,002.93	66,153.56	69,463.15
	<hr/>	<hr/>	<hr/>	<hr/>
Total interest	108,388.03	113,806.51	119,497.32	125,579.28

During the taxable years, and the two years preceding, the Securities Company's books showed balances as follows:

Year	Net Income	Net loss
1918	\$ 57,076.19	
1919	40,305.89	
1920	37,886.82	
1921		\$18,109.18
1922	105,549.04	
1923		446,124.52

The petitioner was vice president and secretary, and her husband was president and treasurer of the company throughout the years in question. During none of the taxable years did the company have cash sufficient to pay the current interest on its notes held by the petitioner and her children. [99]

On December 31, 1923, there was credited to the petitioner and her children, on the journal of the Securities Company, the total amount of interest accrued upon the promissory notes of the company from 1917 to the close of 1923. Corresponding credits appear upon the ledger of the company in the separate "Notes Payable" account of this petitioner. The company, on December 31, 1923, executed renewal notes to the petitioner and her children. The new notes covered the principal of the old notes and all accumulated interest thereon.

The petitioner made her tax returns upon a cash receipts and disbursements basis. The company books were kept on the accrual basis, but did not accrue the interest upon petitioner's notes as it became due, year by year. In 1923 the company set up on its books the total amount of interest accumulated during the preceding six years.

The respondent asserts that petitioner received taxable income, through the constructive receipt of interest in the amounts above set forth, in each of the respective taxable years, and, adding these amounts to her reported gross income for those years, has determined deficiencies thereon as set forth above.

OPINION

Marquette: The question presented here is one of possible constructive receipt of income. The petitioner held promissory notes of a company, bearing interest at 5 per cent per annum. No interest was paid during the taxable years, and the testimony shows that the company did not have sufficient surplus cash in any of the taxable years to pay the current interest upon its outstanding notes. The company did have assets which were acquired, in part, in exchange for its capital stock; in part for the promissory notes here involved; and in part by changes in the investments. That portion of the assets acquired by the company through cash purchases does not appear. The debtor company's stock was all owned by the petitioner, her children, and her husband. It is the respondent's contention that

the assets of the company were available, year by year, to pay the interest due to the petitioner; but that she, an officer [100] and large stockholder in the company, voluntarily gave up the interest for the time being in order that the company might reinvest its money and increase, or at least strengthen, the investments which it held. Therefore, the respondent concludes, the petitioner constructively received the interest due her and is taxable thereon. The petitioner kept her personal accounts and made her income-tax returns upon the cash receipts and disbursements basis.

Section 213 (a) of the Revenue Act of 1918 is identical in language with the same numbered section of the 1921 Act. So far as applicable here, the wording is as follows:

* * * The term "gross income" (a) includes gains, profits, and income derived from * * * interest, rent, dividends, securities * * The amount of all such items * * * shall be included in the gross income for the taxable year in which received by the taxpayer, unless * * * any such amounts are to be properly accounted for as of a different period.

Section 212 (b) of the Revenue Acts of 1918 and 1921, so far as here pertinent, reads:

The net income shall be computed upon the basis of the taxpayer's annual accounting period * * * in accordance with the method of accounting regularly employed in keeping the books of the taxpayer.

The question whether one on a cash receipts and disbursements basis may receive income construc-

tively has been before the Federal courts. In *Mutual Benefit Life Insurance Co. v. Herold*, 198 Fed. 199, the court held that uncollected and deferred premiums, and interest due and accrued but not actually received, did not constitute income within the meaning of the taxing statute. We quote:

At the outset it may be remarked that a statute providing for the imposition of taxes is to be strictly construed, and all reasonable doubts in respect thereto resolved against the government and in favor of the citizen.

This doctrine is supported by *Spreckels Sugar Co. v. McClain*, 192 U. S. 397; *Benziger v. United States*, 192 U. S. 38; *American Net & [101] Twine Co. v. Worthington*, 141 U. S. 468. Quoting, again, from the *Herold* decision:

Since, then, the language of the Act is explicit in permitting only such deductions from gross income as were actually paid during the current year, it would be strange, indeed, if on the opposite side of the account the company were charged with what it had not received during the current year. * * * the word "income" means that which has come in, not that which might have come in, but did not. If expenditures means what has been paid out, or outgoes, then income means what has come in, or receipts. * * * It seems almost to border upon absurdity to speak of income as including that which has not been received, and, which in the ordinary uncertainties of business may never be received. * * * They (interest and deferred premiums) are neither receipts or income until paid.

This Board has also considered the same question in numerous cases. In *John A. Brander*, 3 B. T. A. 231, we held that Brander had constructively received \$2,904.49 credited to him as salary by the corporation of which he was president, but not withdrawn by him. It appeared in that case that the company had ample surplus and cash with which to pay Brander, together with net earnings for the year in question sufficient to pay a dividend of 350 per cent on the outstanding capital stock.

In *Archer L. Kent*, 6 B. T. A. 614, a corporation declared a dividend, amounting to \$17,605.04 on Kent's stock. The parties stipulated that \$7,464.79 of this dividend was payable (in the taxable year) and was unqualifiedly subject to the taxpayer's demand on that date (the taxable year); and we held that Kent had constructively received such portion of the dividend although he did not receive the dividend check, mailed December 31, until January.

In both these cases the debtor company had on hand at the close of the year sufficient cash and surplus with which to pay the amounts due, and those amounts were unqualifiedly set apart and made subject to the taxpayer's demands; but, in the appeal now before us, in no one of the taxable [102] years do we find both these necessary elements occurring. In *Estate of Julius J. Nartzik*, 8 B. T. A. 685, the corporation of which he was president voted him a bonus, for services rendered, of \$25,000. This action was taken in 1920, but the amount was not credited upon the company's books, which were kept

on the accrual basis, until February, 1921, when the credit was made as of December 31, 1920. In disallowing the Commissioner's determination of constructive receipt of the money in 1920, we said:

Before it should be held that a taxpayer constructively received income in any taxable year when he did not, in fact, come into possession of the money or property, it should appear beyond question that the taxpayer, although at liberty, considering the financial requirements and needs of the corporation, to withdraw the amount due him, deliberately chose not to draw or receive the amount owing by the corporation. As was said by the Board in *John A. Brander*, 3 B. T. A. 231, "It was not that the corporation would not pay, but rather that he would not receive. This election to give the corporation the temporary use of the amount was an exercise by him of its enjoyment, and this is one of the primary attributes of income." The \$25,000 in question was not sufficiently available for the decedent's use to constitute a constructive receipt by him. The theory of constructive receipt of income should not be extended beyond the principle announced by the Board in *John A. Brander*, *supra*, and this proceeding is clearly not within the rule announced in that appeal. The fact that the decedent owned practically all of the stock of the corporation had nothing to do with the question whether he received income. The Commissioner argues that "the Board is wholly without informa-

tion as to the corporation's ability to borrow money or to pay it (the bonus) from other sources than its balances of cash held in banks." The mere fact that a creditor of the taxpayer might borrow sufficient money or sell some of the assets and realize sufficient cash to pay the taxpayer the amount due does not make the taxpayer in receipt of income on the cash basis. We are satisfied from the facts in this proceeding that the \$25,000 was not received by the petitioner within the calendar year 1920 within the meaning of the statute and was not, therefore, income for that year. [103]

In an early decision, *A. L. Englander*, 1 B. T. A. 760, we held that salary credited to an employee on the books of a corporation is not taxable income unless it is available for the use of such employee.

In *Edward J. White*, 13 B. T. A. 854, we held that an attorney's retainer fee, contracted for and apparently due and payable before 1920, but not actually paid until that year, was income in the year actually received. And to like effect are numerous other decisions of this Board.

In deciding this, or any other appeal, we must bear in mind that, as was said in *Storage & Transfer Co. v. Heiner*, 20 Fed. (2d) 921, "Taxes are not laid and collected on theory, but on a situation actually existing, as the facts may show that situation to be. Theory is applied in the absence of such facts. * * * Facts, and not bookkeeping entries, give rise to taxable income. In *re Curtis*, 142 N. Y. 219; 36 N. E. 887; *Swift's Estate*, 137 N. Y. 77;

32 N. E. 1096; *Doyle v. Mitchell Bros. Co.*, 247 U. S. 179; *So. Pac. R. R. v. Muentner (C. C. A.)* 260 Fed. 837; *Baldwin Locomotive Works v. McCoach (C. C. A.)*, 221 Fed. 59."

In the present proceeding, we are confronted by these facts: (1) In none of the taxable years did the debtor company have sufficient available cash to pay the current interest due to petitioner; (2) in only one of the taxable years was the petitioner credited upon the books of the company with the amount of interest due her; and in that year the company sustained a net loss of over \$440,000. From the facts of this appeal, and a careful consideration of the governing statutes and the decisions applying them to similar situations, our conclusion must be wholly counter to the determination of the respondent. The debtor company having no available cash with which to pay, and not having made the appropriation for the payment of the interest due this petitioner, it is difficult to see wherein the company's funds were so "unqualifiedly subject to the taxpayer's demand," as to bring this situation within the purview of a constructive receipt of income.

But the respondent argues that the company might have disposed of some of its assets, and thus have obtained the money to pay the petitioner's [104] interest. It is not for us to speculate or theorize upon what might have been, but was not, done. The petitioner was taxable upon her income; the interest which the respondent seeks to impress

with taxes was not received by her and was, therefore, no part of her actual income; the interest due her was never made unqualifiedly subject to her demand. The respondent erred in his determination of deficiencies, and they are disallowed. [105]

EXHIBIT "8"

Treasury Department
Washington

July 1, 1932.

Office of
Commissioner of Internal Revenue
Mrs. Marian Otis Chandler,
c/o John T. Riley,
505 Title Insurance Building,
Los Angeles, California.

Madam:

You are advised that the determination of your tax liability for the year(s) 1929 discloses a deficiency of \$163,175.03, as shown in the statement attached.

In accordance with section 272 of the Revenue Act of 1928, notice is hereby given of the deficiency mentioned. Within sixty days (not counting Sunday as the sixtieth day) from the date of the mailing of this letter, you may petition the United States Board of Tax Appeals for a redetermination of your tax liability.

However, If You Do Not Desire to Petition, you are requested to execute the enclosed agreement form and forward it to the Commissioner of Inter-

nal Revenue, Washington, D. C., for the attention of IT:C:P-7. The signing of this agreement will expedite the closing of your return(s) by permitting an early assessment of any deficiency and preventing the accumulation of interest charges, since the interest period terminates thirty days after filing the enclosed agreement, or on the date assessment is made, whichever is earlier; Whereas If No Agreement Is Filed, interest will accumulate to the date of assessment of the deficiency.

Respectfully,

DAVID BURNET,

Commissioner.

By (Signed) J. C. WILMER,

Deputy Commissioner.

Enclosures:

Statement

Form 882

Form 870 [106]

STATEMENT.

IT:AR:E-1

NF-60D

In re: Mrs. Marian Otis Chandler,
c/o John T. Riley,
505 Title Insurance Building,
Los Angeles, California.
Tax Liability.

Year—1929

Tax Liability—\$178,656.06.

Tax Assessed—\$15,481.03.

Deficiency—\$163,175.03.

The deficiency shown herein is based upon the revised report of Internal Revenue Agent Charles W. Donnally covering your tax liability for the year 1929.

Careful consideration has been accorded your protests dated December 17, 1931 and March 28, 1932, in connection with the findings of the examining officer, and the information submitted at a conference held in the office of the internal revenue agent in charge.

Your return has been adjusted as follows:

Net income reported on return.....\$119,493.11

Add:

1. Salary\$ 19,404.40

2. Error in computation..... .20

3. Interest income .. 661,369.56 680,774.16

Net income adjusted.....\$800,267.27

Explanation of Changes.

1. It is held by this office that in applying the United States Supreme Court decision in the case of Robert K. Malcolm, all community income as defined by Income Tax Ruling 2457, Cumulative Bulletin VIII-1, page 89, must be divided equally between husband and wife where original separate income tax returns were filed. It is necessary, therefore, to include in your return one-half of the salary reported by your husband, which under the ruling referred to above represents community income. Your [107] income has accordingly been increased by one-half of \$38,808.80, or \$19,404.40. A corresponding decrease in income has been made in your husband's return, resulting in an overassessment of tax of which he will be advised in a subsequent communication from this Bureau.

2. Deduction listed on your return were overstated by \$0.20.

3. Interest on notes of the Chandis Securities Company for the years 1916 to 1929, inclusive, paid in stock of the company during 1929, has been included in taxable income.

Interest on these notes, which were originally issued for assets turned over to the company, ran at the rate of 5% compounded annually. The interest through the year 1923 was incorporated in notes, and for subsequent years was accrued in accounts of the corporation. None of the interest was paid prior to 1929, although the corporation, keeping its books and filing its returns on the accrual basis, de-

ducted for each year substantial amounts of interest on this indebtedness.

During the year 1929, arrangements were made whereby notes payable in a total amount of \$3,515,606.88, representing the principal of \$1,938,548.60 and accrued interest of \$1,577,058.28 were turned into the corporation and cancelled in exchange for corporate stock of the same par amount as the total of the principal and accrued interest.

It is contended by you that the relinquishment of the notes and interest debts for stock issued in proportion to the ownership in the notes and debts, after which action the former noteholders possessed more than 80% of the outstanding stock, resulted in a transfer of property to a corporation controlled by the transferors and was a nontaxable exchange under section 112 (b) (5) of the Revenue Act of 1928.

In this connection, it is held that "property" as contemplated by section 112 (b) (5) must be property within the meaning of the tax law generally. Such property must be either income or capital, and capital consists of original capital and capital derived through income.

From this viewpoint, it is believed that an analogy exists in the rulings pertaining to uncollectible interest claimed as a bad debt. In the decision of the United States Board of Tax Appeals in the case of Charles A. Collin, 1 Board of Tax Appeals, 305, it was held that a taxpayer who keeps his accounts on a cash [108] basis may not deduct from gross income as a bad debt an item of accrued interest

which he had not at any time previously treated as income or reported as taxable income.

There could be no loss of property unless the interest had been reported as income. Also, there could be no property transferable for stock until the interest debt claimed as property had been reported as income.

It is held by this office that the transaction in question resulted in a payment of the interest, and interest is an item of income. Section 22(a) of the Revenue Act of 1928.

COMPUTATION OF TAX.

Total net income adjusted.....	\$800,267.27	
Less:		
Capital net gain included.....	290.00	
		<hr/>
Ordinary net income adjusted.....	\$799,977.27	
Less:		
Dividends	110,679.46	
		<hr/>
Net income subject to normal tax.....	\$689,297.81	
Normal tax at $\frac{1}{2}\%$ on \$4,000.00.....	20.00	
Normal tax at 2% on \$4,000.00.....	80.00	
Normal tax at 4% on \$681,297.81.....	27,251.91	
Surtax on \$799,977.27.....	151,655.45	
Tax at $12\frac{1}{2}\%$ on \$290.00.....	36.25	
		<hr/>
Total	179,043.61	
Less:		
Earned income credit.....	\$210.36	
Tax paid at source.....	177.19	387.55
		<hr/>
Total amount assessable.....	\$178,656.06	
Tax previously assessed.....	15,481.03	
		<hr/>
Deficiency in tax.....	\$163,175.03	

COMPUTATION OF EARNED
INCOME CREDIT.

Earned net income.....	\$ 20,460.40
Normal tax at $\frac{1}{2}\%$ on \$4,000.00.....	20.00
Normal tax at 2% on \$4,000.00.....	80.00
Normal tax at 4% on \$12,460.40.....	498.42
Surtax on \$20,460.40.....	243.02
<hr/>	
Total tax	841.44
Credit of 25%.....	210.36

Consent, which will expire December 31, 1932, except as extended by the provisions of section 277 of the Revenue Act of 1928, is on file.

[110]

Receipt of a copy of the within is hereby admitted this 19th day of March 1940

EUGENE HARPOLE

Special Attorney

Bureau of Internal Revenue

Attorney for Petitioner

[Endorsed]: Filed Mar. 19, 1940. [129]

[Title of District Court and Cause.]

AFFIDAVIT

State of California

County of Los Angeles—ss.

Charles W. Donnally, being first duly sworn, deposes and says:

That he is employed as an Internal Revenue Agent by the Bureau of Internal Revenue, assigned

to duty at Los Angeles, California, and has been so employed since the year 1920.

That on or about September 15, 1931, in the course of his official duty, he made an investigation of the income tax liability for the calendar year 1929 of Marian Otis Chandler, and in the course of said investigation on or about said date, he went to 2330 Hillhurst Drive, Los Angeles, the address of Marian Otis Chandler given on her 1929 income tax return and demanded to see her with regard to her said return, and that he was informed that H. E. Downing was her representative with regard to her income tax returns [131] and instructed to go see Mr. Downing and told that Mr. Downing would furnish whatever information he desired; that thereafter he went to see Mr. Downing and advised Mr. Downing that he wished to make an examination of the income tax liability for the calendar year 1929 of Marian Otis Chandler and that Mr. Downing stated to him that he had charge, for Mrs. Chandler, of matters pertaining to her income tax return and that he would answer any questions that Mr. Donnelly had with regard to her 1929 return. Affiant then requested from Mr. Downing that he produce all the books and records and documents pertaining to an exchange by Mrs. Marian Otis Chandler and other members of the Chandler family of notes of the Chandis Securities Company for stock of said company. Among other documents, affiant requested of Mr. Downing the notes, which were supposed to have been cancelled in exchange for stock. Mr.

Downing told affiant that the notes had been in his possession for a long period prior to December 31, 1929; that the notes had been cancelled in 1929 and that all legal steps had been taken for the issuance of the stock of the Chandis Securities Company prior to the close of 1929, but that the mechanical operation of issuing the certificates was delayed as the new certificates had not been received from the printer.

Affiant further states that on several visits to the office of the Chandis Securities Company for the purpose of examining the 1929 income tax return of Marian Otis Chandler he repeatedly requested from Mr. Downing that said notes be produced and was repeatedly told by Mr. Downing that the notes had been misplaced [132] and that Mr. Downing was unable to produce them, but was repeatedly assured by Mr. Downing that the notes were cancelled in 1929 and that if they were found they would so indicate on their face. Mr. Downing stated that a former bookkeeper, who was ill with tuberculosis, and who had been away from the office for a long time and was not expected back for months, if ever, was responsible for misplacing the notes, and that said bookkeeper had taken care of the mechanical work in connection with the records and due to his illness the work of bringing the records up to date had been delayed.

Affiant further states that he relied absolutely upon the statements of Mr. Downing that the notes has been misplaced and were not available, and that

the notes had been cancelled in 1929 and would so indicate on their face if found, in preparing his recommendation to his superiors that the exchange of the notes for the stock was taxable in 1929.

CHARLES W. DONNALLY

Subscribed and sworn to before me this 5 day of April, 1940.

[Seal]

T. G. ALBRIGHT

Notary Public in and for the County of Los Angeles, State of California.

My Commission Expires October 22, 1940. [133]

[Title of District Court and Cause.]

AFFIDAVIT

State of California

County of Los Angeles—ss.

Warner E. Williams, being first duly sworn, deposes and says:

1. That he refers to and incorporates by reference the affidavit he executed on March 4, 1940, on file as Exhibit "C" to the Petition for Production of Records in this Proceeding.

2. That the reasons that it is necessary that representatives of the Bureau of Internal Revenue examine the books and records of the Chandis Securities Company for the years 1916 to 1930, inclusive, and question said H. E. Downing in order to determine whether Marian Otis Chandler committed a fraud against the Revenue by failing to

report in the income tax return filed by her for the calendar year 1930 a large sum of asserted interest income received by her from the said Chandis Securities Company [134] in the year 1930 are as follows:

(a) There were exchanged in the year 1930, by Mrs. Marian Otis Chandler, certain notes and alleged interest thereon for stock in the Chandis Securities Company. Said notes consisted of interest and of principal. The original notes, of which the notes exchanged in 1930 were in part renewals, were issued in 1916, or shortly thereafter. Without an examination of the books and records of the Chandis Securities Company from 1916 to 1930, inclusive, it is impossible to determine how much of the face amounts of the notes actually represents interest and how much principal, and hence impossible to determine how much interest Marian Otis Chandler should have reported in her income tax return for 1930.

(b) In order to determine the amount of interest income received by Marion Otis Chandler in 1930, it is necessary to determine the value of the stock which she received in that year as interest income in exchange for the notes and accrued interest thereon. In order to determine the value of said stock, it is necessary to determine when the assets of the corporation behind the stock were acquired, the manner in which they were acquired, and from whom they were acquired. These facts can be determined only by an examination of the

books and records of the Chandis Securities Company from 1916 to 1930.

3. Attached hereto, as Exhibit 1, is a true and correct copy of a letter dated November 25, 1931, sent by the office of the Internal Revenue Agent in Charge to Mrs. Marian Otis Chandler. [135]

4. Attached hereto, as Exhibit 2, is a true and correct copy of a Protest dated December 17, 1931, and filed on said date with the office of the Internal Revenue Agent in Charge, Los Angeles, signed by Marian Otis Chandler.

5. Attached hereto, as Exhibit 3, is a true and correct copy of a letter dated March 28, 1932, addressed to the Internal Revenue Agent in Charge, Los Angeles, and supplementing the Protest dated December 17, 1931 (Exhibit 2 hereto), filed by George M. Thompson and Associates by John T. Riley.

6. Attached hereto, as Exhibit 4, is a true and correct copy of a letter dated April 4, 1932, addressed to Mrs. Marian Otis Chandler.

7. Attached hereto, as Exhibit 5, is a memorandum received by the Special Advisory Committee of the Bureau of Internal Revenue on April 27, 1933, from George M. Thompson, Certified Public Accountant, Suite 505 Title Insurance Building, Los Angeles, California, Marian Otis Chandler's representative before the Bureau of Internal Revenue.

8. Attached hereto, as Exhibit 6, is a true and correct photostatic copy of the income tax return

filed for the calendar year 1929 by Marian Otis Chandler.

9. Attached hereto, as Exhibit 7, is a true and correct photostatic copy of the income tax return filed for the calendar year 1930 by Marian Otis Chandler.

10. Attached hereto, as Exhibit 8, is a true and correct photostatic copy of a Waiver of Right to File a Petition with the United States Board of Tax Appeals signed by Marian Otis [136] Chandler, dated January 28, 1933 and filed with the Internal Revenue Agent in Charge, Los Angeles, January 31, 1933.

11. Attached hereto, as Exhibit 9, is a true and correct photostatic copy of the corporation income tax return filed by the Chandis Securities Company for the calendar year 1923.

WARNER E. WILLIAMS

Subscribed and sworn to before me this 6 day of April, 1940.

T. G. ALBRIGHT

Notary Public in and for the County of Los Angeles, State of California.

ST/mm 4/5/40 [137]

EXHIBIT 1

IT:R

Form 850—Rev. Sept., 1931

Treasury Department
Internal Revenue Service
939 South Broadway
Los Angeles, Calif.

Office of Internal Revenue Agent
in Charge

In re: Income Tax
Date of Report: Nov 25 1931

Recommendation:

Years—1929

Additional Tax—\$21,269.68

Overassessment—

Penalties—

Total—

Mrs. Marian Otis Chandler,
2330 Hillhurst Drive,
Los Angeles, California.

Madam:

The recommendations which this office proposes to make with respect to your income tax liability as the result of a recent examination by an internal revenue agent are shown in the statement attached.

If you acquiesce in the proposed tax liability the inclosed Form 870 should be executed and forwarded to this office. Your consent on Form 870 to the

prompt assessment of any deficiency indicated will stop the running of interest to be assessed on such deficiency under the provisions of section 283(d) of the Revenue Act of 1926 or section 292 of the Revenue Act of 1928, upon a date not later than thirty days after the filing of Form 870 properly executed. Unless such consent is filed the interest to be assessed under the law upon any deficiency indicated runs to the date the deficiency is assessed and the assessment may be made only as provided by section 274(a) of the Revenue Act of 1926 and/or section 272(a) of the Revenue Act of 1928.

Should you desire to make immediate payment without awaiting formal assessment and notice and demand, you should communicate with the collector of internal revenue at Los Angeles, California, inclosing this letter, or a copy thereof. If payment is so made the interest period will terminate on the date of payment.

If you do not acquiesce in the proposed recommendations you should file a protest in writing with this office within 15 days from the date of this letter. Any protest so filed will be given careful consideration, and, if you so desire, you will be given an opportunity for a [138] hearing before the recommendations are forwarded to Washington.

Arrangements will be made by this office upon your request to answer any questions which may occur to you in your review of these recommendations.

In any event please sign the inclosed form

acknowledging receipt of this letter and related papers and return such form to this office.

Respectfully,

Internal Revenue Agent in Charge.

Inclosures:

Statement of adjustments

Form 870.

Form of acknowledgment.

McM [139]

Form 886-T-August, 1928

Treasury Department

Examining Officer:

Internal Revenue Service

Chas. W. Donnally

Name Mrs. Marian Otis Chandler,

2330 Hillhurst Drive,

Los Angeles, Calif.

STATEMENT OF TOTAL TAX LIABILITY

Year—1929

Tax Previously Assessed—\$15,481.03

Adjustments Proposed in Accompanying Report

Deficiency—\$21,269.68

Overassessment

Correct Tax Liability—\$36,750.71

Totals

Note

The amount shown in the first column of the above statement is the amount assessed on the original return except as indicated in the following summary of adjustments previously made; [140]

* * * * *

Table of Contents

Preliminary Statement

Schedule 1—Block Adjustments,

Schedule 2—Computation of Tax

Schedule 3—Earned Income Credit

Preliminary Statement

Taxpayer's husband, Harry Chandler, filed separate return and claimed full exemption.

Deficiency in tax due to the addition of \$70,097.32 accrued interest due taxpayer from the Chandis Securities Company, which was paid by the issuance of stock of the debtor corporation. Also, the sum of \$19,404.40, representing 50% of the salary of taxpayer and her husband, was transferred from the husband's gross income to that of taxpayer. Interest from tax-free bonds was transferred from regular interest block to item 4 of the return.

Changes were taken up with Mr. H. E. Downing, taxpayer's representative, who does not agree to the adjustment of interest from the Chandis Securities Company. All other items have Mr. Downing's approval. [141]

Schedule 1

BLOCK ADJUSTMENTS

	Return	Additions	Deductions	Corrected
1. 25% depreciation	1,056.00	19,404.40		20,460.40
3. Interest	7,228.45	70,097.32	520.00	76,805.77
4. Interest, tax-free	8,339.45	520.00		8,859.45
7. Rents	1,689.34			1,689.34
8. Profits	1,342.87			1,342.87
9. Dividends	110,679.46			110,679.46
12. Total	130,335.57	89,501.72		219,837.29
13. Interest	5,379.87			5,379.87
14. Taxes	2,810.39			2,810.39
17. Contributions	2,942.00			2,942.00
			.20 error in addition	
19. Total	11,132.46			11,132.26
20. Net income	119,203.11	89,501.92		208,705.03
Capital net gain...	290.00			290.00
Total income.....	119,493.11	89,501.92		208,995.03

Schedule 1-A

Explanation of Items

Item 1

The income reported by taxpayer under "Salary" represents depreciation on a house in which she lives and which is owned by the Chandis Securities Company. The charge is one made in prior examination to which taxpayer agreed and since, the item has been included when filing returns. The addition of \$19,404.40 is one-half of the salary earned by herself and husband, Harry Chandler, the latter having reported his own salary and that of his wife. A like sum has been deducted from the income reported by husband. [142]

Item 3

The addition of \$70,097.32 is accrued interest on an indebtedness due taxpayer from the Chandis Securities Company. The indebtedness was discharged in 1929 by the issuance of the capital stock of the company. The deduction of \$520.00 is on tax-free bond interest paid by Hollywood Hospital Company in the sum of \$325.00 and by Jackson Furniture Company in the sum of \$195.00. All interest items have been checked and found to agree with the information reports with the exception as noted above. The information reports show tax-free interest from the Globe Grain Company in the sum of \$240.00 and the Central Manufacturing Company in the sum of \$390.00. These two items belong to Philip and Helen Chandler, her children, who have included the amounts in gross income when filing their 1929 returns.

All other items have been checked and found to agree with records and information returns filed with the exception of the dividends from the Times Mirror Company. The information report shows \$98,838.00 whereas taxpayer reports but \$93,138.00, a difference of \$5,700.00. Helen Chandler reported \$2,850.00 and Philip Chandler \$2,850.00, covering their ownership in the stock held in their mother's name. This division is correct.

Schedule 2

Year ended 12/31/29

COMPUTATION OF TAX

Net income (from Schedule 1).....		208,995.03
Less: Capital net gain.....	290.00	290.00
	<hr/>	<hr/>
Income subject to surtax.....		208,705.03
Less: Dividends	110,679.46	110,679.46
	<hr/>	<hr/>
Balance subject to normal tax.....		98,025.57
		[143]
Normal tax at $\frac{1}{2}\%$ on \$4,000.00.....	20.00	
Normal tax at 2% on \$4,000.00.....	80.00	
Normal tax at 4% on \$90,025.57.....	3,601.02	
Surtax on \$208,705.03.....	33,401.01	
Tax at $12\frac{1}{2}\%$ on capital net gain of \$290.00	36.25	
	<hr/>	
Total tax		37,138.28
Less: Credit for earned net income (Schedule 3)	210.38	
Income tax paid at source.....	177.19	
	<hr/>	
		387.57
		<hr/>
Total tax assessable.....		26,750.71
Tax previously assessed.....		15,481.03
		<hr/>
Additional tax to be assessed.....		21,269.68

Schedule 3
Year ended 12/31/29

COMPUTATION OF EARNED INCOME CREDIT

Earned net income.....	20,460.40
Less personal exemption and credit for dependents—claimed by husband.....	—
Balance	20,460.40
Normal tax at $\frac{1}{2}\%$ on \$4,000.00.....	20.00
Normal tax at 2% on \$4,000.00.....	80.00
Normal tax at 4% on \$12,460.40.....	498.42
Surtax on \$20,460.40—.....	243.02
Total tax	841.44
Credit of 25%.....	210.38
	[144]

EXHIBIT 2
PROTEST

Internal Revenue Agent in Charge,
939 South Broadway,
Los Angeles, California.

In re: Marian Otis Chandler,
2330 Hillhurst Drive,
Los Angeles, California.

The above named taxpayer hereby protests to the determination of income as set forth in letter of the Internal Revenue Agent in Charge dated November 25, 1931, and as a basis of this Protest alleges as follows:

- (1) Taxpayer is an individual.
- (2) The year involved is the calendar year 1929 and the amount of tax in dispute is \$21,269.68.
- (3) An itemized schedule of the findings to

which the taxpayer takes exception is as follows:

(a) The Internal Revenue Agent has erroneously increased net income by the sum of \$70,097.32.

(4) The facts upon which the taxpayer relies in support of her contentions are as follows:

(a) The taxpayer is a stockholder in the Chandis Securities Company and during the calendar year 1929 and prior thereto was the payee under certain promissory notes signed by the Chandis Securities Company.

(1) During the calendar year 1929, the Chandis Securities Company in connection with a reorganization, acquired from this taxpayer the notes of the said Company held by the taxpayer.

(2) At the time the notes were acquired, interest had accrued in the sum of \$70,097.32. The Internal Revenue Agent has [145] erroneously included this sum as income which was not paid to the taxpayer and was not credited to her account or unqualifiedly subject to her demand. It is the contention of the taxpayer that the transaction whereby the taxpayer transferred notes to the Chandis Securities Company for its stock represents an exempt exchange in connection with a reorganization.

If the above contention is not accepted, then an

oral conference to be held in Los Angeles is respectfully requested.

This Protest is not being made for the purpose of delay but only for the reasons hereinbefore set forth.

(Signed) MARIAN OTIS CHANDLER

State of California

County of Los Angeles

Marian Otis Chandler being duly sworn says that she is the taxpayer herein-before named, and that she is duly authorized to verify the foregoing protest; that she has read the foregoing protest or had the same read to her and is familiar with the statements contained therein and that the facts stated are true.

(Signed) MARIAN OTIS CHANDLER

Subscribed and sworn to before me this 17th day of December, 1931.

(Signed) C. O. DENNING

Notary Public In and for the County of Los Angeles, State of California.

I hereby certify that the foregoing Protest was prepared under my supervision upon facts furnished by the taxpayer, which facts I believe to be correct.

(Signed) JOHN T. RILEY [146]

EXHIBIT 3

George M. Thompson, C.P.A. John T. Riley
R. E. Davis, C.P.A. Marshall D. Hall, C.P.A.
Geo. Vacher, C.P.A. —
W. J. Scott, C.P.A. Attorneys at Law
Sam Barnett, C.P.A.
Wm. N. Simpkins

George M. Thompson
Certified Public Accountant
and Associates

Specializing in Income and Estate Tax Practice
Suite 505 Title Insurance Bldg.

433 South Spring Street

Telephone Trinity 3478

Los Angeles, California

Revenue Agent in Charge

Received

Mar

31

1932

Los Angeles Division

March 28, 1932.

Internal Revenue Agent in Charge,
939 South Broadway,
Los Angeles, California.

In re: Marian Otis Chandler and Related Cases
Dear Sir:

Supplementing Protest dated December 17, 1931,
taking exception to the proposed assessment of ad-
ditional income taxes to the above taxpayer for the

year 1929, the following contention, in addition to that stated in the Protest, is hereby submitted.

(a) The Internal Revenue Agent has erroneously determined that the taxpayer realized a gain in an exchange of notes for stock in a corporation contrary to the provisions of Section 112 (b) (5) of the Revenue Act of 1928.

The facts are that the taxpayer and her children on December 31, 1929, were the owners of notes executed by the Chandis Securities Company that had a face value together with accrued interest aggregating \$3,515,606.88.

The taxpayer and her children exchanged the said notes for 35,153 shares of stock of the Chandis Securities Company. Immediately after the exchange, the Chandis Securities Company had issued and outstanding an aggregate of 40,162 shares.

It is, therefore, contended that the taxpayer and her children immediately after the exchange were in control of the corporation and that the transaction is clearly within the meaning of Section 112 (b) [147] (5) of the Revenue Act of 1928. See G. C. M. 4196, C. B. Dec., 1928 page 241.

Respectfully yours,

GEORGE M. THOMPSON

AND ASSOCIATES,

By (Signed) JOHN T. RILEY

JTR:EWR [148]

EXHIBIT 4

IT:FC

939 South Broadway,

April 4, 1932.

Mrs. Marian Otis Chandler,
c/o John T. Riley,
505 Title Insurance Building,
Los Angeles, California.

Madam:

Reference is again made to your income tax liability for the year 1929 as stated in a Revenue Agent's report and to your protests against the findings.

Careful consideration has been given to your contentions in conference with the result that the conferee has modified the findings of the Revenue Agent's report and this office has reached a decision on the issue raised, as follows:

The stock of the Chandis Securities Company received in liquidation of the interest due on the notes of the company for the years 1916 to 1929, inclusive, should be treated as income in the year 1929 to the extent of the value of the stock at the date of acquisition. I. T. 2258 V-1 C. B. 10. Since no evidence has been submitted to the contrary, the value is regarded as equivalent to the total amount of the interest.

The transaction can not be construed otherwise than resulting in a payment of the interest and interest is an item of income. Section 22 (a) Revenue Act of 1928. The amount of de-

iciency set forth in the accompanying schedule is in lieu of, and not in addition to, the deficiencies for prior years computed on the theory of constructive receipt of the annual interest.

[149]

Consideration has been given to the seeming unfairness of proposing a deficiency for the taxable year while deficiencies for prior years based on the same items were still pending, but it is only by so doing that the matter could be placed in position for a complete settlement of the interest question which, it is understood, the taxpayer's representative will initiate with the Bureau at Washington at an early date.

There is enclosed a recomputation of tax liability in accordance with the above decision.

Your protests and the Revenue Agent's report, accompanied by the foregoing recommendation, have been forwarded to the Commissioner of Internal Revenue, Washington, D. C. for consideration and appropriate action.

Respectfully,

FHG/Mc

(Signed) C. R. KRIGBAUM

Enclosure:

C. R. KRIGBAUM,

Internal Revenue Agent in Charge

Recomputation

of tax liability [150]

Conferee's Revision
Statement of Total Tax Liability

Year—1929

Previously Assessed—\$15,481.03

Deficiency—\$163,175.01

Total Tax Liability—\$178,656.04

Net income per Revenue Agent's report of November 25, 1931.....		\$208,995.03
Add: Interest received from Chandis Securities Company	\$661,369.56	
Less: Amount included in agent's report	70,097.32	591,272.24
Net income		\$800,267.27
Less: Capital net gain.....	\$ 290.00	
Dividends	110,679.46	110,969.46
Income subject to normal tax.....		\$689,297.81
Normal tax at $\frac{1}{2}\%$ on \$4,000.00.....	20.00	
Normal tax at 2% on \$4,000.00.....	80.00	
Normal tax at 4% on \$681,297.81.....	27,251.91	
Surtax on \$799,977.27.....	151,655.45	
Tax at $12\frac{1}{2}\%$ on capital net gain of \$290.00.....	36.25	
Total		\$179,043.61
Less: Credit for earned net income (no change).....	\$210.38	
Income tax paid at source	177.19	387.57
Tax liability		\$178,656.04
Previously assessed		15,481.03
Deficiency		\$163,175.01

EXHIBIT 5

Marian Otis Chandler, Docket No. 67466
Memorandum in Reply to Contentions in
Sixty-Day Letter

George M. Thompson
Certified Public Accountant
Suite 505 Title Insurance Bldg.
Los Angeles, California [152]

It is our contention that the transaction by which Marian Otis Chandler, et al, acquired stock of the Chandis Securities Company in exchange for notes of that company plus accrued interest thereon and old stock of the Chandis Securities Company was a non-taxable exchange under Section 112 (b) (5) of the Revenue Act of 1928 or Section 112 (b) (3) of that Act.

The sixty-day letter takes the position that in order to come within Section 112 (b) (5), we must exchange property of a kind which is within the meaning of the tax law generally, and attempts to define what is property. To quote from the sixty-day letter:

“Such property must be either income or capital, and capital consists of original capital and capital derived through income.”

We contend very forcibly that accrued interest is property within the meaning of the tax law generally and that the position taken by the Bureau is entirely without foundation, and is not supported by any decisions or by the law itself, and fail to see by

what stretch of the imagination it could be otherwise construed. We cite the case of *Anna Taylor*, Docket No. 7042, 3 B. T. A. 1201, in which the Board says

“The term ‘property’ has frequently been held by the courts to include every interest one may have in any and everything that is the subject of ownership. *Frorer v. People*, 141 Ill. 171; 31 N. E. 395; *Watson v. City of Boston*, 209 Mass. 18; 95 N. E. 302.” [153]

In its decision in the above case, the Board discussed the case of *Lynch v. Alworth-Stephens Co.*, 267 U. S. 364; 45 Sup. Ct. 274, and said:

“In the disposition of that case, the court said that there was nothing to suggest that the word ‘property,’ from which the deduction on account of exhaustion was permitted, is used in any restricted sense. * * * There is nothing to suggest the term ‘property, real, personal or mixed’ as found in Section 202 of the Revenue Act of 1921, should be given a more limited meaning than the term ‘property’ for the purpose of exhaustion, contained in Section 12 (a) (2) of the Revenue Act of 1916. The taxpayer had the right to receive royalties on oil recovered. She could not have enforced and protected that right. She could not have been deprived of it without due process of law.”

In the instant case, the taxpayer had a right to receive interest. This right was enforceable and she could have protected that right.

In the case of *J. S. F. Crayton v. Commissioner of Internal Revenue*, 11 B. T. A. 1375, the Board in its opinion quoted from the case of *Martin & Earle v. Maxwell*, 86 S. C. 67; 1 S. E. 962, as follows:

“It is true, as has been often said, that a contingent remainder is not technically an estate but a mere possibility of an estate in the future; but that is very far from saying that it is not property. The term ‘property’ used in the bankruptcy act, is of the broadest possible signification, embracing everything that has exchangeable value, or goes to make up a man’s wealth—every interest or estate which the law regards of sufficient value for judicial recognition.” Citing several cases. [154]

The Board then said:

“Restriction of the meaning and scope of the term ‘property’ as used in the taxing statutes may not be imputed. *Lynch v. Alworth-Stephens Co.*, 267 U. S. 364. See also *Anna Taylor*, 3 B. T. A., 1201, and other cases there cited.

The reasonable and practicable interpretation of the statute is that it includes all forms of and interest in property whatsoever.”

Certainly, under those decisions, the item of accrued interest on notes receivable which the taxpayer transferred to the Chandis Securities Com-

pany in exchange for stock was "property" within the meaning of the Revenue Act.

Insofar as the contention of the Bureau is concerned that property must be either income or capital, we assume the Bureau refers to the fact that the accrued interest has never been reported as income, but the Revenue Act of 1928 takes care of such transactions in Section 113 (6), which provides that the stockholder in an exempt reorganization must use as a basis for the determination of profit or loss of such stock in a subsequent sale, the cost basis of the property exchanged for such stock.

The sixty-day letter tries to create an analogy between the particular issue and the rulings pertaining to uncollectible interest claimed as a bad debt. We contend that there is no analogy whatsoever; that the conditions are entirely different. In the case cited by the Bureau, the taxpayer attempted to take as a deduction from his income, a bad debt represented by an item of accrued interest which had never been reported as taxable income. Certainly, in that case, the taxpayer was not entitled to deduct such an amount as a loss and we fail to [155] see where the reasoning in that particular case has any connection whatsoever with the point at issue. We have no fault to find with the argument that there can be no loss deductible unless the interest had been reported as income, **BUT THIS TAXPAYER IS NOT ATTEMPTING TO TAKE A LOSS.** Should the taxpayer attempt to take a loss upon the subsequent sale of this stock

received in exchange for the notes and accrued interest and base this loss not only upon the amount invested in the notes but also include as a loss the accrued interest thereon, which has not been reported as income subject to tax, we thoroughly agree that he would not be entitled to take any loss represented by the accrued interest, but that is a condition that does not confront us at the present time and will arise only in the event of a sale of the stock received in the exchange.

It is respectfully submitted that the arguments and cases cited by the Bureau in the sixty-day letter are not at all in point and this taxpayer should not be compelled to go to trial on issues which are so clear as not to require any further discussion.

[Endorsed]: Received Apr. 27, 1933. Special Advisory Committee. [156]

Section 1101 of the Revenue Act of 1926 as amended by Section 603 of the Revenue Act of 1928 and Section 1101 of the Revenue Act of 1932.

JUAL INCOME TAX RETURN

Do Not Write in These Spaces

SEC. 1101, REV. ACT. 1932

FOR NET INCOMES FROM SALARIES OR WAGES OF MORE THAN \$5,000

INCOMES FROM BUSINESS, PROFESSION, RENTS, OR SALE OF PROPERTY

Tax 4-7-32
Penalty 0.70
Interest 15.92

For Calendar Year 1929

This Return Shall Be Filed With the Collector of Internal Revenue for Your District on or Before March 15, 1930

Total 5978.38

PRINT NAME AND ADDRESS PLAINLY BELOW

Base on RA 4-7-32
Audited by 7-7-1-1932

MARION OTIS CHAMBERLAIN

(Name)

2430 Milhurst Drive

(Street and Number, or Rural Route)

Los Angeles

(City or Town)

California

(State)

Occupation

Lawyer



RECEIVED WITH REMITTANCE

Mar 25 1930

Cash Check 15.92

By J. H. F. F. F.

Cashed 15.92

As 6.00

- Are you a citizen or resident of the United States? Yes
- If you filed a return for 1928, to what Collector's office was it sent? Los Angeles
- Is this a joint return of husband and wife? Yes
- State name of husband or wife if a separate return was made and the Collector's office where it was sent. Mar. Chamberlain, Los Angeles
- Were you married and living with husband or wife on the last day of your taxable year? Yes
- If not, were you on the last day of your taxable year supporting in your household one or more persons closely related to you? No
- If your status in respect to questions 5 and 6 changed during the year, state date and nature of change. No
- How many dependent persons (other than husband or wife) under 18 years of age or incapable of self-support were receiving their chief support from you on the last day of your taxable year? None

INCOME		Amount received	Expenses paid
1. Salaries, Wages, Commissions, etc. (State name and address of employer)		\$ 1,000.00	
2. Income from Business or Profession (From Schedule A)			
3. Interest on Bank Deposits, Notes, Corporation Bonds, etc. (except interest on tax-free covenant bonds)		7.28	
4. Interest on Tax-free Covenant Bonds Upon Which a Tax was Paid at Source		0.00	
5. Income from Partnerships (State name and address)			
6. Income from Fiduciaries (State name and address)			
7. Rents and Royalties (From Schedule B)		1.00	
8. Profit from Sale of Real Estate, Stocks, Bonds, etc. (From Schedule C)		1.00	
9. Dividends on Stock of Domestic Corporations		210.00	
10. Taxable Interest on Liberty Bonds, etc. (From Schedule E)			
11. Other Income (including dividends on stock of foreign corporations) (State nature of income)			
(a)			
(b)			
12. TOTAL INCOME IN ITEMS 1 TO 11		\$ 1,218.28	

DEDUCTIONS

- Interest Paid
- Taxes Paid (Explain in Schedule F)
- Losses by Fire, Storm, etc. (Explain in Table at foot of page 2)
- Bad Debts (Explain in Schedule F)
- Contributions (Explain in Schedule F)
- Other Deductions Authorized by Law (Explain in Schedule F)
- TOTAL DEDUCTIONS IN ITEMS 13 TO 18
- NET INCOME (Item 12 minus Item 19)

EARNED INCOME CREDIT

21. Earned Income (not over \$30,000)	\$ 1,218.28
22. Less Personal Exemption and Credit for Dependents	
23. Balance (Item 21 minus 22)	\$ 500.00
24. Amount taxable at 14% (not over \$4,000)	\$ 70.00
25. Amount taxable at 25% (not over \$4,000)	100.00
26. Amount taxable at 5% (balance over \$8,000 of Item 23)	
27. Normal Tax (14% of Item 24)	20.00
28. Normal Tax (25% of Item 25)	25.00
29. Normal Tax (5% of Item 26)	
30. Surtax on Item 21	
31. Tax on Earned Net Income (total of Items 27 to 30)	\$ 40.00
32. Credit of 25% of Tax (not over 25% of Items 30, 44, 45, and 46)	\$ 10.00

COMPUTATION OF TAX (See Instruction 23)

33. Net Income (Item 20 above)	\$ 1,218.28
34. Less: Dividends (Item 9)	\$ 210.00
35. Interest on Liberty Bonds, etc. (Item 10)	
36. Credit for Dependents	
37. Personal Exemption	
38. Total of Items 34 to 37	\$ 1,008.28
39. Balance (Item 33 minus 38)	\$ 210.00
40. Amount taxable at 14% (not over \$4,000)	\$ 29.40
41. Balance (Item 39 minus 40)	\$ 180.60
42. Amount taxable at 25% (not over \$4,000)	\$ 45.15
43. Amount taxable at 5% (Item 41 minus Item 42)	\$ 135.45
44. Normal Tax (14% of Item 40)	\$ 29.40
45. Normal Tax (25% of Item 42)	\$ 11.29
46. Normal Tax (5% of Item 43)	\$ 6.77
47. Surtax on Item 20 (see Instruction 23)	
48. Tax on Net Income (total of Items 44 to 47)	\$ 47.46
49. Tax on Capital Gain or Loss (12 1/2% of Col. 8, Sched. D)	
50. Total of or difference between Items 48 and 49	\$ 47.46
51. Less Credit of 25% of Tax on Earned Income (Item 32)	\$ 10.00
52. Total Tax (Item 50 minus 51)	\$ 37.46
53. Less Income Tax Paid at Source	
54. Income Tax paid to a foreign country or U. S. possession	
55. Balance of Tax (Item 52 minus Items 53 and 54)	\$ 37.46

AFFIDAVIT

I swear (or affirm) that this return, including the accompanying schedules and statements, has been examined by me, and to the best of my knowledge and belief, is a true and complete return made in good faith for the taxable year stated, pursuant to the Revenue Act of 1928 and the Regulations issued thereunder.

(If return is made by agent, the reason therefor must be stated on this line)

Sworn to and subscribed before me this 15 day of March, 1930.

NOTARIAL SEAL

John J. Chamberlain
(Signature of administrator of estate)

(Title)

Marion Otis Chamberlain
(Signature of individual or agent)

(Address of agent)

An amended return must be marked "Amended" at top of return

Checks and drafts will be accepted only if payable at par

Notes	Total	2 % at Source	Interest Received	
			Wholly Exempt	Wholly Taxable
Kern County Road Improvement.....	480.00		480.00	
L. A. County Sanitation District.....	275.00		275.00	
L. A. Traction Co.....	250.00			250.00
Mortgage Guarantee Certificates.....	1,566.67			1,566.67
Merced Irrigation District.....	600.00		600.00	
Municipal Ownership Certificates.....	300.00		300.00	
Mortgage Insurance Certificates.....	300.00			300.00
Nevada California Elect. Co.....	250.00	250.00		
Otis Steel Corp.....	120.00	120.00		
Peoples Light & Power Co.....	189.45	189.45		
Province of Santa Fe-Argentina.....	280.00			280.00
Pan American Petroleum Corp.....	300.00	300.00		
Redondo Home Tel. Company.....	300.00	300.00		
Southern Cal. Bldg. & Loan Assn.....	780.00		300.00	480.00
San Joaquin Light & Power Co.....	550.00	550.00		
Santa Monica Bay Telephone Co.....	300.00	300.00		
San Diego First National Co.....	275.00	275.00		
Savoy-Plaza Co.....	330.00	330.00		
Soiland Building.....	260.00			260.00
Utilities Power & Light.....	275.00	275.00		
Various St. Imp. Bonds.....	1,179.53		1,179.53	

Bonds	Notes	Total	2 % at Source	Interest Received	
				Wholly Exempt	Wholly Taxable
	J. R. Askew-Times Route.....	267.05			267.05
	A. S. Bradford.....	172.50			172.50
	H. J. W. Chevey-Times Route.....	301.00			301.00
	H. B. Freeman.....	175.00			175.00
	C. R. Graves-Times Route.....	83.58			83.58
	C. E. Harris-Times Route.....	131.55			131.55
	Mary Mulgreen.....	450.00			450.00
	Miss F. V. Thornburg.....	750.00			750.00
	Trust 3020.....	1,000.00			1,000.00
	Savings Account (CNB).....	141.10			141.10
	Total.....	\$19,262.43	\$8,339.45	\$3,694.53	\$7,228.45
					[158]

MARIAN OTIS CHANDLER

INCOME TAX, 1929

PROFIT FROM SALE OF REAL ESTATE, STOCKS, BONDS

Kind of Property	Date Acquired	Schedule C		Net Profit
		Amount Received	Cost	
San Diego First Nat. Co. Bond.....	Jan. 1928	\$ 3,090.00	\$ 3,000.00	\$ 90.00
Associated Gas & Elect. Co. rights.....		13.17		13.17
Peoples Light & Power Co. Stock.....	Oct. 1928	5,008.50	4,183.60	824.90
Peoples Light & Power Co. Scrip.....		3.83		3.83
Kolsters Radio—Warrants.....		35.97		35.97
Celite Co.—Bond.....	Nov. 1927	15,375.00	15,000.00	375.00
		<u>\$23,526.47</u>	<u>\$22,183.60</u>	<u>\$1,342.87</u>
				[159]

MARIAN OTIS CHANDLER

INCOME TAX 1929

DIVIDENDS	<u>Dividends</u>
Associated Gas and Electric Co.....\$	344.94
American Capital Corporation.....	300.00
Bullock's Inc.	700.00
Consolidated Steel Corporation.....	262.50
Cities Service	300.00
Citizens National Bank.....	1,220.00
District Bond Company.....	560.00
Discount Corporation	976.00
First National Bank.....	464.00
Federal Water Service.....	475.40
Goodyear Textile Mills.....	350.00
Great Western Power Company.....	800.00
Gladding McBean Co.....	746.30
Hunt Bros. Packing Company.....	400.00
Janss Investment Company.....	150.00
L. A. Athletic Club.....	20.40
Pacific Southwest Realty Company.....	1,380.00
Richfield Oil Company.....	560.00
Standard Oil of California.....	562.50
Security Trust and Savings Bank.....	360.00
Santa Monica Bay Telephone.....	128.33
Southern California Gas Company.....	300.00
Southern California Gas Corporation.....	195.00
Superior Portland Cement.....	330.00
Schumacher Wall Board.....	230.00
Security First National Trust & Savings Bank	1,070.72
The Times-Mirror Company.....	93,138.00
Tidewater Associated Oil.....	300.00
Union Oil Associates.....	720.95
Union Oil Company.....	1,097.34
Tri Utilities Corporation.....	18.00
Tyre Bros., Glass Company.....	165.83
Whiting Finance Company.....	1,602.25
Woodward Bennett Packing Company.....	350.00
Ever-Ready Drug Company.....	100.00
	<u>\$110,679.46</u>

MARIAN OTIS CHANDLER
INCOME TAX—1929

<u>City and County</u>	<u>Taxes Paid</u> <u>Interest Paid</u>	
	<u>Total</u>	
Calipatria Lots	\$	64.40
Calexico Lot		666.63
Imperial Valley Farm Lands.....		95.42
Lombardy Road Lot.....		263.87
Lot 8-15—Tract 7803.....		203.11
Lot 5-14—Tract 6193.....		105.89
Lot 8-1 —Tract 7803.....		160.14
Lot 12-50—Tract 5609.....		139.74
Lot 12-10—Tract 8235.....		181.67
Wilshire & Vermont.....		500.00
Personal Property Tax.....		429.52
		<hr/>
		<u>\$2,810.39</u>

Interest Paid

Contract—Lot 8-15—Tract 7803.....	\$	642.25
“ Lot 8-1 —Tract 7803.....		1,330.00
“ Lot 12-50—Tract 5609.....		577.43
“ Lot 12-10—Tract 8235.....		205.19
“ Wilshire and Vermont.....		2,625.00
		<hr/>
		<u>\$5,379.87</u>

MARIAN OTIS CHANDLER

INCOME TAX—1929

CONTRIBUTIONS	<u>Contributions</u>
Kobe College (corporation) Japan.....	\$ 500.00
Chicago Theological Seminary.....	500.00
Federal Council of Churches.....	40.00
United Veteran	40.00
National Library for Blind.....	5.00
Y. W. C. A.....	250.00
Travelers Aid Society.....	100.00
China Famine Relief.....	50.00
Convalescent Home, Childrens Hospital.....	10.00
War Mothers Benefit.....	10.00
Community Industries	35.00
Near East Relief.....	25.00
Home for Aged (Palms).....	25.00
Assistance League	5.00
Near East College Association.....	250.00
Ruth Sanitarium	100.00
Mary Martha Home for Girls.....	20.00
National Save-a-Life League.....	15.00
American Foundation for Blind.....	50.00
Russian Refugees Benefit.....	5.00
Seaman's Church Institute.....	20.00
American Merchant Marine Library.....	10.00
Playground and Recreation Association.....	25.00
L. A. Tuberculosis Association.....	2.00
First Congregational Church.....	250.00
L. A. Orphans Home.....	100.00
Maternity Cottage	500.00
	<hr/>
	\$2,942.00
	<hr/>

SCHEDULE A—INCOME FROM BUSINESS OR PROFESSION

(Not filled in)

SCHEDULE B—INCOME FROM RENTS AND ROYALTIES (See Instruction 7)

1. Kind of Property	2. Amount Received	3. Cost or Value As of March 1, 1913, Whichever Greater	4. Depreciation (Explain in table at foot of page)	5. Repairs	6. Other Expenses (Itemize below)	7. Net Profit (Enter as Item 7)
Calexico Lot	\$ 15.50	\$	\$	\$	\$	\$ 15.50
Imperial Valley Land	113.10					113.10
Oil Lease	971.41	Less 27½% depletion				704.27
Ground Lease	2,160.00	Less amortization	\$1,303.53			856.47
Explanation of deductions claimed in Column 6						\$1,689.34

SCHEDULE C—PROFIT FROM SALE OF REAL ESTATE, STOCKS, BONDS, ETC.

(Not filled in)

SCHEDULE D—CAPITAL NET GAIN OR LOSS FROM SALE OF ASSETS HELD MORE THAN
TWO YEARS (See Instruction 8a)

1. Kind of Property	2. Date Acquired	3. Date Sold	Mo. Day Year	5. Depreciation Allowable Since Acquisition	6. Cost or Value As of March 1, 1913 Whichever Greater	7. Subsequent Improvements, and Capital Deductions	8. Net Gain or Loss (Enter 12½% as Item 49)
			Mo. Day Year				
Bonds.....	Jan '27	Feb '29		\$.....	\$ 960.00	\$.....	\$ 40.00
Bonds.....	May '25	Feb '29		.....	5,000.00	.....	250.00
							<u>\$290.00</u>

State how property was acquired.....

SCHEDULE E—INTEREST ON LIBERTY BONDS AND OTHER OBLIGATIONS OR SECURITIES

(See Instruction 10)

1. Obligations or Securities	2. Interest Received or Accrued	3. Amount Owned	4. Principal Amount Exempt From Taxation	5. Amount Owned In Excess of Exemption	6. Interest on Amount in Excess of Exemption (Enter as Item 10)
(a) Obligations of a State, Territory, or political subdivision thereof, or the District of Columbia.....	\$3,694.53	\$52,681.10	All	XXXXXX XX	XXXXXX XX
(b) Securities issued under Federal Farm Loan Act or as Amended, and Certificates of Indebtedness issued after June 17, 1929 .....	.....	.....	All	XXXXXX XX	XXXXXX XX
(c) Liberty 3½% Bonds and other obligations of United States issued on or before September 1, 1917, and obligations of U. S. possessions.....	.....	.....	All	XXXXXX XX	XXXXXX XX
(d) Liberty 4% and 4¼% Bonds, Certificates of Indebtedness issued before June 18, 1929, Treasury Bonds and Savings Certificates .....	.....	.....	
(e) Treasury Notes .....	.....	.....	
			\$5,000	\$	\$
			None		

SCHEDULE F—EXPLANATION OF DEDUCTIONS CLAIMED IN ITEMS 1, 14, 16, 17 AND 18

(Not filled in)

EXPLANATION OF DEDUCTIONS FOR DEPRECIATION CLAIMED IN SCHEDULES A AND B

(Not filled in)

EXPLANATION OF DEDUCTION FOR LOSSES BY FIRE, STORM, ETC., CLAIMED IN SCHEDULE A,
AND IN ITEM 15

(Not filled in)

[163]

INDIVIDUAL INCOME TAX RETURN

Do Not Write in These Spaces

FOR NET INCOMES FROM SALARIES OR WAGES OF MORE THAN \$5,000
AND INCOMES FROM BUSINESS, PROFESSION, RENTS, OR SALE OF PROPERTY

For Calendar Year 1930

File This Return With the Collector of Internal Revenue for Your District on or before **APRIL 15, 1931**

PRINT NAME AND ADDRESS PLAINLY BELOW

Marian Otis Chandler

8330 Hillhurst Ave.

(Street and number, or rural route)

Los Angeles

(Post office)

Los Angeles

(County)

California

(State)

District

(Collector's Stamp)

Cash Check M.O. Cert. of Ind.

First Payment

MAR 3 1931

- Are you a citizen or resident of the United States? **Yes**
- If you filed a return for 1929, to what Collector's office was it sent? **Sixth-California**
- In this a joint return of husband and wife? **No**
- State name of husband or wife if separate return was made and the Collector's office where it was sent **Mary Chandler Sixth-California**

INCOME

1. Salaries, Wages, Commissions, etc. (State name and address of employer)

A record received (If none, write "None")

Community Income as per schedule attached

30 320 00

2. Income from Business or Profession. (From Schedule A)

7 158 82

3. Interest on Bank Deposits, Notes, Corporation Bonds, etc. (except interest on tax-free covenant bonds)

7 446 49

4. Interest on Tax-free Covenant Bonds Upon Which a Tax was Paid at Source

5. Income from Partnerships. (State name and address)

6. Income from Fiduciaries. (State name and address)

7. Rents and Royalties. (From Schedule D)

2 970 32

8. Profit from Sale of Real Estate, Stocks, Bonds, etc. (From Schedule C)

5 55

9. Taxable Interest on Liberty Bonds, etc. (From Schedule E)

10. Dividends on Stock of Domestic Corporations. (State name and address)

77 335 84

11. Other Income (including dividends on stock of foreign corporations). (State nature of income)

(a)

(b)

12. TOTAL INCOME IN ITEMS 1 TO 11

125 237 16

DEDUCTIONS

13. Interest Paid

29 069 31

14. Taxes Paid. (Explain in Schedule F)

2 413 28

15. Losses by Fire, Storm, etc. (Explain in Table at foot of page 2)

16. Bad Debts. (Explain in Schedule F)

17. Contributions. (Explain in Schedule F)

9 256 00

18. Other Deductions Authorized by Law. (Explain in Schedule F)

19. TOTAL DEDUCTIONS IN ITEMS 13 TO 18

40 758 59

20. NET INCOME (Item 12 minus Item 19)

84 478 57

EARNED INCOME CREDIT

COMPUTATION OF TAX (See Instruction 23)

21. Earned Income (not over \$30,000)	\$30,000 00	33. Net Income (Item 20 above)	\$84,478 57	44. Normal Tax (1 1/2% of Item 40)	\$ 60 00
22. Less Personal Exemption and Credit for Dependents		34. Liberty Bond Interest (Item 9)		45. Normal Tax (3% of Item 42)	94 28
23. Balance (Item 21 minus 22)	\$30,000 00	35. Dividends (Item 10)	\$77,335 84	46. Normal Tax (5% of Item 43)	
24. Amount taxable at 1 1/2% (not over \$4,000)	\$4,000 00	36. Credit for Dependents		47. Surtax on Item 20 (see Instruction 23)	\$710 93
25. Amount taxable at 5% (not over \$4,000)	\$4,000 00	37. Personal Exemption		48. Tax on Net Income (total of Items 41 to 47)	\$9665 21
26. Amount taxable at 5% (balance over \$4,000 of Item 23)	\$22,000 00	38. Total of Items 34 to 37	\$77,335 84	49. Tax on Capital Gain or Loss (12 1/2% of Col. 8, Sched. D)	146 56
27. Normal Tax (1 1/2% of Item 24)	\$ 60 00	39. Balance (Item 38 minus 38)	\$71,442 73	50. Total of or difference between Items 48 and 49	\$9718 65
28. Normal Tax (3% of Item 25)	120 00	40. Amount taxable at 1 1/2% (not over \$4,000)	\$4,000 00	51. Less Credit of 25% of Tax on Earned Income (Item 32)	\$238 67
29. Normal Tax (5% of Item 26)	1100 00	41. Balance (Item 39 minus 40)	\$31,442 73	52. Total Tax (Item 50 minus 51)	\$9480 09
30. Surplus on Item 21	\$90 00	42. Amount taxable at 5% (not over \$4,000)	\$4,000 00	53. Less Income Tax Paid at Source	146 93
31. Tax on Earned Net Income (total of Items 27 to 30)	\$2160 00	43. Amount taxable at 5% (Item 41 minus 42)	\$	54. Income Tax paid to a foreign country or U.S. possession	
32. Credit of 25% of Tax (not over 25% of Items 30, 44, 45, and 46)	\$565 00			55. Balance of Tax (Item 52 minus Items 53 and 54)	\$9233 15

AFFIDAVIT

I swear (or affirm) that this return, including the accompanying schedules and statements, has been examined by me, and to the best of my knowledge and belief, is a true and complete return made in good faith for the taxable year stated, pursuant to the Revenue Act of 1926 and the Regulations issued thereunder.

(If return is made by agent, the reason therefor must be stated on this line)

Sworn to and subscribed before me this **7th** day of **March**, 1931.

1931.

Marian Otis Chandler
(Signature of taxpayer or agent)

NOTARIAL SEAL

(Signature of officer administering oath)

(Title)

(Address of agent)

An amended return must be filed in the city of Los Angeles, State of California

Checks and drafts will be accepted only if payable at par

8-50951

HARRY CHANDLER & MARIAN OTIS CHANDLER

INCOME TAX 1930

Community Income

Harry Chandler

The Times Mirror Co.....	\$ 7,800.00	
Directors Fees Yosemite Park & Curry Co.	10.00	
Directors Fees Western Air Express..	250.00	
Directors Fees Mortgage Guarantee Co.	20.00	
Directors Fees Compania Industrial Jabonera del Pacific S. A.....	21,726.31	
Chandis Securities Company.....	12,000.00	
$\frac{1}{4}$ Depreciation charged to expense by C. S. Co. on Residence House & Automobile	639.23	\$42,445.54
<hr/>		

Marian Otis Chandler

Chandis Securities Co.....	\$17,555.50	
$\frac{1}{4}$ Depreciation charged to expense by C. S. Co. on Residence House & Automobile	639.23	\$18,194.73
<hr/>		

Total Income	\$60,640.27
--------------------	-------------

$\frac{1}{2}$ to Marian Otis Chandler.....	\$30,320.14
$\frac{1}{2}$ to Harry Chandler.....	30,320.13

[165]

MARIAN OTIS CHANDLER

INCOME TAX 1930

Interest Received

BONDS	Total	2 % at Source	Wholly Exempt	Wholly Taxable
American National Gas Corp.....	\$ 715.00	\$ 715.00	\$	\$
Boyle Mfg. Co.....	97.33	97.33	—	—
Brownstein Louis Realty Co.....	325.00	325.00	—	—
Beverly Crest	420.00	420.00	—	—
Bullocks Inc.	600.00	600.00	—	—
Bell Air Property.....	650.00	650.00	—	—
Commercial Discount Corpn.....	300.00	300.00	—	—
City of Orange.....	210.00	—	210.00	—
Central Manufacturing District.....	300.00	300.00	—	—
City of Burbank Improvement.....	350.00	—	350.00	—
Commonwealth of Australia.....	100.00	—	—	100.00
Chamber of Commerce.....	180.00	180.00	—	—
Foreman & Clark.....	300.00	300.00	—	—
Golden State Milk Products.....	300.00	300.00	—	—
Hollywood Hospital	325.00	—	325.00	—
Home Service Co.....	650.00	650.00	—	—

BONDS	Total	2 % at Source	Wholly Exempt	Wholly Taxable
Jackson Furniture Co.....	195.00	195.00	—	—
Kern County Improvement.....	480.00	—	480.00	—
L. A. Sanitation District.....	275.00	—	275.00	—
L. A. Traction Co.....	500.00	—	—	500.00
Mortgage Guarantee Certificate.....	1,433.33	—	—	1,433.33
Merced Irrigation District.....	600.00	—	600.00	—
Municipal Ownership Cdfs.....	300.00	—	300.00	—
Mortgage Insurance Corp.....	263.33	—	—	263.33
Nevada Calif. Electric Corp.....	250.00	250.00	—	—
Otis Steel Corpn.....	145.47	145.47	—	—
Province of Santa Fe.....	175.00	—	—	175.00
Pan American Petroleum Corpn.....	300.00	300.00	—	—
Redondo Home Telephone.....	313.33	313.33	—	—
San Luis Obispo—Road Imp.....	248.10	—	248.10	—
San Bernardino “ “.....	83.25	—	83.25	—
San Joaquin Light & Power.....	496.67	496.67	—	—
Santa Monica Bay Telephone.....	205.00	205.00	—	—
San Diego First Nat'l. Co.....	98.69	98.69	—	—
Savoy Plaza Corp.....	330.00	330.00	—	—
Soiland Building Corp.....	520.00	—	—	520.00
Utilities Power & Light.....	275.00	275.00	—	—
U. S. Rubber Corp.....	45.00	—	—	45.00

BONDS	Total	2 % at Source	Wholly Exempt	Wholly Taxable
NOTES				
J. R. Askew.....	232.05	—	—	232.05
A. S. Bradford.....	122.50	—	—	122.50
H. J. W. Cheney.....	301.00	—	—	301.00
Mr. C. Dodd.....	304.92	—	—	304.92
H. B. Freeman.....	87.50	—	—	87.50
C. R. Graves.....	194.38	—	—	194.38
Mary Mulqueen.....	427.50	—	—	427.50
Trust 3020 (Distribution).....	1,000.00	—	—	1,000.00
Miss F. V. Thornburg.....	840.00	—	—	840.00
Savings Accounts (C. N. B.).....	99.22	—	—	99.22
Int. on over assessment of Income Tax 1920.....	33.09	—	—	33.09
So. California Building & Loan.....	780.00	—	300.00	480.00
				[167]
BONDS—(Street Improvement)				
Devonshire Ave.	110.27	—	110.27	—
First Street	4.16	—	4.16	—
Hermosa Beach	94.23	—	94.23	—
Linda Vista Pasadena.....	143.73	—	143.73	—
Santa Monica	15.03	—	15.03	—
Wilshire Blvd.	257.32	—	257.32	—
Whitsett Ave.	258.09	—	258.09	—
Total.....	\$18,659.49	\$7,446.49	\$4,054.18	\$7,158.82
				[168]

MARIAN OTIS CHANDLER

INCOME TAX 1930

Rentals & Royalties—Schedule “B”

Citizens National Bank Lease (\$180.00 Monthly)	
(1930 Income \$2,160.00 Amortization).....	\$1,303.53 \$ 856.47
Calexico Lot	45.00
Imperial Valley Farm Lands.....	19.66
Santa Fe Springs Oil Lease Total Received	
(\$792.04 less 27½%).....	574.23
Rosemary Route	1,474.96
	<hr/>
To Line 7	\$2,970.32
	<hr/> <hr/>

[169]

MARIAN OTIS CHANDLER

INCOME TAX 1930

Dividends

Associated Gas & Electric.....	\$ 162.50
American Capital Corp.....	300.00
Bullocks	700.00
Consolidated Steel	350.00
Cities Service	146.57
Citizens National Bank.....	1,722.00
District Bond Co.....	567.48
Discount Corp. of Calif.....	244.00
Federal Water Service.....	559.20
Goodyear Textile Mills.....	350.00
Great Western Power Co.....	800.00
Gladding McBean Co.....	958.81
Hunt Brothers Packing Co.....	400.00
Janss Investment Co.....	600.00
L. A. Athletic Club.....	20.40
L. A. Investment Co.....	28.80
Massachusetts Investors Trust.....	345.68
Pacific S. W. Realty Co.....	746.25
Pacific Finance Co.....	586.08
Richfield Oil Co. of Cal.....	560.00
Standard Oil Co. of Calif.....	642.63
So. California Gas Co.....	300.00
So. California Gas Corp.....	195.00
Superior Portland Cement.....	330.00
Schumacher Wallboard	230.00
Security First National Bank.....	2,141.44
Security Company	100.00
Times Mirror Company.....	58,824.00
Tidewater Associated Oil.....	300.00
Trustee Standard Oil Shares.....	226.50
Union Oil Associates.....	824.51
Union Oil Co. of Calif.....	1,225.61
Tri Utilities Co.....	230.40
Tyre Bros. Glass Co.....	420.00
Merchants Finance Co.....	847.98
Woodward Bennett Packing Co.....	350.00

To Line 10.....\$77,335.84

MARIAN OTIS CHANDLER

INCOME TAX 1930

Contributions

American Brotherhood for Blind.....	\$ 10.00
Disabled Veterans	16.00
University of So. California.....	50.00
Childrens Hospital Society.....	10.00
China Child Welfare.....	60.00
Traveler's Aid Society.....	100.00
Federal Council of Churches.....	20.00
King's Daughters & Sons.....	25.00
Sheriffs Relief Assoc.....	2.00
First Congregational Church.....	1,250.00
L. N. Brunswick (Maisons Claires).....	25.00
Seamen's Church Institute.....	20.00
National Recreation Assoc.....	25.00
Crippled Childrens Guild.....	5.00
L. A. Orphans Home.....	100.00
Maternity Cottage	500.00
Golden Rule Foundation.....	25.00
Community Industries	10.00
National Society Prevention Tuberculosis.....	3.00
California Institute of Technology.....	7,000.00

To Line 17.....\$9,256.00

[171]

MARIAN OTIS CHANDLER

INCOME TAX 1930

City, County & Irrig. Taxes Paid

Calipatria Lots	\$ 63.50
Calexico Lot	656.83
Imperial Valley Farm Lands.....	96.51
Pasadena Lot #9 Tract #7988.....	146.88
Lot 18 Block 15 Tract #7803.....	183.54
“ 5 “ 14 “ 6193.....	95.92
“ 8 “ 1 “ 7803.....	180.49
“ 12 “ 50 “ 5609.....	183.54
“ 12 “ 10 “ 8235.....	79.34
Wilshire & Vermont.....	450.00
Personal Property Tax.....	276.73

To Line 14..... 2,413.28

Interest Paid

Chandis Securities Co.....	\$ 1,448.66
Lot 18, Block 5 Tract #7803 (Janss Inv. Co.)	420.00
Lot 8, Block 1 Tract #7803 (H. Wisdom).....	1,190.00
“ 12 “ 50 “ #5609 (Buchanan)	320.82
“ 12 “ 10 “ #8235 (Janss Inv. Co.).....	87.85
Wilshire & Vermont.....	2,300.00
Interest on deficiency of 1921 Income Tax.....	13,612.63
“ “ “ “ 1922 “ “	4,966.86
“ “ “ “ 1923 “ “	4,742.49

To Line 13.....\$29,089.31

[172]

SCHEDULE A—INCOME FROM BUSINESS OR PROFESSION

(Not filled in)

SCHEDULE B—INCOME FROM RENTS AND ROYALTIES

(Not filled in)

SCHEDULE C—PROFIT FROM SALE OF REAL ESTATE, STOCKS, BONDS, ETC. (See Instruction 8)

1. Kind of Property	2. Date Acquired	3. Amount Realized	4. Depreciation		5. Cost or Value As of March 1, 1913, Whichever Greater	6. Subsequent Improvements (Enter as Item 8)	7. Net Profit
			Allowable Since Acquisition	Acquisition			
Bonds—U. S. Rubber Corp.....	1930	\$9,900.00	\$9,902.00		\$.....	\$.....	\$ 2.00
Rights—Trustees—Standard Oil	1930	7.55	—		.....	.....	7.55
State how property was acquired.....							5.55

SCHEDULE D—CAPITAL NET GAIN OR LOSS FROM SALE OF ASSETS HELD MORE THAN TWO YEARS (Not filled in)

SCHEDULE E—INTEREST ON LIBERTY BONDS AND OTHER OBLIGATIONS OR SECURITIES
(See Instruction 9)

1. Obligations or Securities	2. Interest Received or Accrued	3. Amount Owned	4. Principal Amount Exempt From Taxation	5. Amount Owned in Excess of Exemption	6. Interest on Amount in Excess of Exemption (Enter as Item 9)
(a) Obligations of a State, Territory, or political subdivision thereof, or the District of Columbia	\$3,754.18	\$62,122.66	All	XXXXX XX	XXXXXX XX
(b) Securities issued under Federal Farm Loan Act, Treasury Bills, and Certificates of Indebtedness issued after June 17, 1929			All	XXXXX XX	XXXXXX XX
(c) Liberty 3½% Bonds and other obligations of United States issued on or before September 1, 1917, and obligations of U. S. possessions			All	XXXXX XX	XXXXXX XX
(d) Liberty 4% and 4¼% Bonds, Certificates of Indebtedness issued before June 18, 1929, Treasury Bonds and Savings Certificates				\$	\$
(e) Treasury Notes			None		

SCHEDULE F—EXPLANATION OF DEDUCTIONS CLAIMED IN ITEMS 1, 14, 16, 17 AND 18

(Not filled in)

EXPLANATION OF DEDUCTION FOR DEPRECIATION CLAIMED IN SCHEDULES A AND B

(Not filled in)

EXPLANATION OF DEDUCTION FOR LOSSES BY FIRE, STORM, ETC., CLAIMED IN SCHEDULE

A AND IN ITEM 15 (Not filled in)

[173]

Form 1000
U. S. DOMESTIC REVENUE

AUDITED

TAX LIABILITY
OVERPAID \$

PENALTY
TAX LIABILITY
UNPAID \$

CLAIM FOR REFUND
FOR
CLAIM CONTROL

UNDER
PAID (F. A.)

DATE
2-28-24

CORPORATION INCOME TAX RETURN

For Calendar Year 1923

File This Return With the Collector of Internal Revenue for Your District on or Before March 15, 1924

PRINT PLAINLY CORPORATION'S NAME AND BUSINESS ADDRESS

GRANDIS SECURITIES COMPANY

100 North Broadway St.

Los Angeles, California

Date of Incorporation November, 1916

Under the Laws of What State or Country California

Page 1 of Return
DO NOT WRITE IN THESE SPACES

SERIAL NUMBER
751071

FILE CODE

6th CALIFORNIA
Recorded and Indexed

FIRST PAYMENT

RECEIVED
G. L. (Collector's Stamp)
JUN 1 1924
LOS ANGELES OFFICE

KIND OF BUSINESS selling, holding and leasing Real-Estate IS THIS A CONSOLIDATED RETURN? No.

GROSS INCOME		
1. Gross Sales from Trading or Manufacturing, Less Returns and Allowances		
2. Less Cost of Goods Sold:		
(a) Inventory at beginning of year		
(b) Merchandise bought for sale		
(c) Cost of manufacturing or otherwise producing goods		
(d) Total of lines (a), (b), and (c)		
(e) Less inventory at end of year		
3. Gross Profit from Trading or Manufacturing (Item 1 minus Item 2)		
4. Gross Profit from Operations Other Than Trading or Manufacturing		
(a)		
(b)		
(c)		
5. Interest on Bank Deposits, Notes, Mortgages, and Corporation Bonds		82 744 29
6. Divs.		30 341 77
7. Royalties		
8. Profit from Sale of Real Estate, Stocks, Bonds, and other Capital Assets (From Schedule F)		64 127 90
9. Dividends on Stock of Domestic Corporations		141 276 48
10. Other Income (including dividends received on stock of foreign corporations)		63 857 66
(a)		
(b)		
(c)		
11. TOTAL INCOME IN ITEMS 3 TO 10		392 348 10

DEDUCTIONS		
12. Compensation of Officers (From Schedule C)		14 900
13. Loss on Business Property		
14. Repairs (From Schedule D)		
15. Interest		138 577 33
16. Taxes (From Schedule E)		11 770 63
17. Losses by Fire, Storm, etc. (From Schedule F)		
18. Bad Debts (From Schedule G)		4 123
19. Dividends (From Schedule H)		141 276 48
20. Depreciation (resulting from exhaustion, wear and tear, or obsolescence) (From Schedule I)		8 260 92
21. Amortization of War Facilities		
22. Depletion of Mines, Oil and Gas Wells, Timber, etc.		
23. Other Deductions Not Reported Above. (Explain below, or on separate sheet):		
(a)		81 690 41
(b)		
(c)		
(d)		
(e)		
24. TOTAL DEDUCTIONS IN ITEMS 12 TO 23		1 000 618 84
25. NET INCOME (Item 11 minus Item 24)		618 270 94

COMPUTATION OF TAX

26. Net Income (Item 25 above)		
27. Less Credit of \$2,000 (for a domestic corporation having a net income of less than \$25,000)		
28. Balance (Item 26 minus Item 27)		
29. Income Tax (12 1/2 % of Item 28)		
30. If the Net Income of a Domestic Corporation is Less Than \$25,000, Enter the Amount in Excess of \$25,000		
31. Total Tax (Item 29 plus Item 30)		
32. Less: Income Tax Paid at Source (This credit can only be allowed to a nonresident foreign corporation)		
33. Income and Profits Taxes Paid to a Foreign Country or to a Possession of the United States by a domestic corporation		
34. Balance of Tax (Item 31 minus Items 32 and 33)		

An amended return must be marked "Amended" at top of return

COMPUTATION

Checks and drafts will be accepted only if payable at par



SCHEDULE K.—BALANCE SHEETS. (See Instruction 26.)

Items.	BEGINNING OF TAXABLE PERIOD.		END OF TAXABLE PERIOD.	
	Amount.	Total.	Amount.	Total.
ASSETS.				
1. Cash		\$ 2,503.83		\$ 106,758.88
2. Notes receivable		641,738.29		781,877.06
3. Accounts receivable	\$ 269,095.60		\$ 95,982.40	
Less reserve for bad debts		269,095.60		95,982.40
4. Inventories:				
Raw materials	\$		\$	
Work in process				
Finished goods				
Supplies				
5. Investments (describe fully):				
Bonds: U. S. Liberty Bonds	\$ 90,543.87		\$ 169,793.87	
Other	35,176.22		29,024.81	
Stocks of domestic corporations	1,910,625.51	2,036,348.60	2,628,616.48	2,827,435.16
6. Loans (describe fully):				
Trusts	\$ 401,776.88		\$ 498,964.99	
7. Deferred charges:				
Prepaid insurance	\$		\$	
Prepaid taxes				
Miscellaneous		22,966.19	90,546.90	90,546.90
8. Capital assets:				
Land		393,306.32		474,725.96
Buildings	\$ 44,947.49		\$ 44,947.49	
Machinery and equipment				
Furniture and fixtures	14,402.38		14,402.38	
Delivery equipment				
Automobiles	18,571.95		18,571.95	
Less reserves for depreciation and depletion	\$ 77,921.82		\$ 77,921.82	
9. Patents				
10. Good will	32,213	45,708.82	40,483.99	37,427.83
11. Other assets (describe fully):	\$		\$	
12. Total Assets		\$3,813,444.53		\$4,913,719.18
LIABILITIES.				
13. Notes payable		\$2,162,074.01		\$2,825,843.28
14. Accounts payable		157,976.10		68,379.79
15. Accrued expenses (describe fully):				
Deferred Credits	\$ 88,185.66		\$ 178,911.10	
16. Other liabilities (describe fully):				
Trusts	\$ 21,500	21,500	\$ 242,000.77	242,000.77
17. Capital stock:				
Preferred stock (less stock in treasury)	\$		\$	
Common stock (less stock in treasury)	500,000	500,000	500,000	500,000
18. Surplus	\$ 883,708.76		\$1,098,584.24	1,098,584.24
19. Undivided profits				
20. Total Liabilities		\$3,813,444.53		\$4,913,719.18

Remarks

SEC 1734		8 500	
(a) Interest on obligations of the United States and its agencies			
(b) Interest on obligations of the United States, its agencies, and its instrumentalities			
(c) Interest on State, local, bonded issues under Federal Farm Loan Act			
(d) Dividends on domestic stock owned under Federal Farm Loan Act			
(e) Dividends on domestic stock owned under Section 302(a) of the Revenue Act of 1938		141	274
(f) Dividends of the Interstate public utility paid upon the death of the insured			
(f) Other items of sustainable income (to be detailed):			
(1)			
(2)			
(3)			
4. Charges against reserves for bond debts, at Dec 31, page 1 of return, to net an addition to a reserve			
5. Charges against reserves for contingencies, etc. (to be detailed):			
(a) Losses reported not on books		37	654
(b)			
(c)			
6. Total of Lines 1 to 6, inclusive		430	839
7. Total from Line 14		44	099
8. Net profit for year as shown by books, before any adjustments are made (Carries 14 & minus Line 6)		474	939
9. Surplus and undivided profits as shown by balance sheet at close of preceding taxable period		863	708
10. Other credits to surplus (to be detailed):			
(a) Stock dividend from The		662	000
(b) Surplus items from Afford Co		19	907
(c)			
11. Total of Lines 7 to 9, inclusive		1	109
12. Surplus and undivided profits as shown by balance sheet at close of taxable period (Line 10 minus Line 11)		11	086
13. Surplus and undivided profits as shown by balance sheet at close of taxable period (Line 11 plus Line 12)		1	098

QUESTIONS.



Gross Income

* * * * *

Deductions

* * * * *

25. Net Income (Item 11 minus Item 24).....\$ None

Computation of Tax

34. Balance of Tax (Item 31 minus Items
32 and 33)\$ None

[179]

AFFIDAVIT.

We, the undersigned, president and treasurer of the corporation for which this return is made, being severally duly sworn, each for himself deposes and says that this return, including the accompanying schedules and statements has been examined by him and is, to the best of his knowledge and belief, a true and complete return made in good faith, for the taxable period as stated, pursuant to the Revenue Act of 1921 and the Regulations issued under authority thereof.

HARRY CHANDLER

President.

MARIAN OTIS CHANDLER

Treasurer.

Sworn to and subscribed before me this 14 day of March, 1924.

(Seal)

ARTHUR CRUM,

Notary Public In and for the County of Los Angeles, State of California. [180]

CHANDIS SECURITIES COMPANY
Income Tax—1923

Schedule B

SCHEDULE B—PROFIT FROM SALE OF REAL ESTATE,
STOCKS, BONDS, AND OTHER CAPITAL ASSETS:

1. Kind of Property	2. Date Acquired	3. Amount Received	4. Depreciation	5. Cost	6. Net Profit	7. Net Loss
(Lot 24—Blk. 60—Owensmouth.....)	Oct. 31, 1919	\$ 850.00		\$ 1850.00		
				(3.75 Asses't.		\$ 3.75
Republic of France—8% Bonds.....	Sept. 23, 1920	5,102.50		5,115.00		12.50
Real Estate (Lot SE Cor. Washington & Grand.)	Jan. 27, 1923	50,000.00		33,769.03	\$16,230.97	
“ “ (Lot 32—Blk. 30—Tract 1200).....	Jan. 1, 1917	650.00		551.73	98.27	
“ “ (Lot 40—Blk. 30—Tract 1200).....	Jan. 1, 1917	700.00		601.73	98.27	
“ “ (Lot 15—Blk. 31—Tract 1200).....	Jan. 1, 1917	825.00		601.73	223.27	
“ “ (Lot 26—Blk. 40—Tract 1200).....	Jan. 1, 1917	700.00		551.73	148.27	
“ “ (Lots 1108-1109-1110—Tract 1000).....	Jan. 1, 1917 (See Schedule Below)				25,216.52	
“ “ (503 No. Broadway—Caldron.....)	Jan. 1, 1917 “ “ “				1,100.00	
“ “ (Lot 340—Tract 1000—Erastus Nichol.....)	Jan. 1, 1917 “ “ “				4,440.00	
“ “ (Lot 99—Tract 1875.....)	Jan. 1, 1917	1,870.00			1,870.00	
“ “ (Lot 1107—Tract 1000.....)	Jan. 1, 1917 (See Schedule Below)				14,718.58	
Total profit.....					\$64,144.15	16.25
Deduct loss.....					16.25	
Net profit.....					\$64,127.90	

Explanatory to Schedule B

Description of Property	Sales Price	Cost	Percentage of Profit	Collections—1923	Profit Returnable—1923
Lots 1108-1109-1110 Tract 1000.....	\$142,000.00	\$71,500.00	\$49.648%	\$50,790.00	\$25,216.52
503 No. Broadway.....	10,000.00	5,000.00	50 %	2,200.00	1,100.00
Lot 340—Tract 1000.....	34,495.50	23,881.50	44.4 %	10,000.00	4,440.00
Lot 1107—Tract 1000.....	89,397.00	24,381.00	72.72 %	20,262.82	14,718.58

Income Tax—1923

SCHEDULE G—BAD DEBTS:

Name	Amount	Remarks
T. P. Murray.....	\$ 215.00	Worthless
Community Arts Alliance.....	1,000.00	Out of Business
W. F. McShane.....	1,600.00	Bankrupt
Imogene, Francis.....	35.00	Uncollectible, address unknown
George King.....	10.00	" " "
Mrs. I. McGuire.....	8.00	" " "
Mrs. Wm. Murphy.....	25.00	" " "
Harry Riefier.....	5.00	" " "
L. M. Solomon.....	5.00	" " "
Merch E. Perry.....	20.00	" " "
Carrie Otis.....	1,000.00	Worthless
F. N. Dowd.....	100.00	Uncollectible, address unknown
Carlos J. Brecino.....	50.00	" " "
F. L. Kendall.....	50.00	" " "
	<u>\$4,123.00</u>	

SCHEDULE I—DEPRECIATIONS:

1. Kind of Property	2. Date Acquired	3. Age When Acquired	4. Probable Life	5. Cost	Depreciation Charged Off	
					This Year	Previous Years
Automobile—Chandler.....	1919	New	5 years	\$ 1,558.10	\$ 111.62	\$ 1,246.48
" —Ford—Sedan.....	1920	"	5 years	1,002.80	200.56	601.68
" —Hudson.....	1919	"	5 years	2,515.00	203.00	2,012.00
" —Lincoln.....	1921	"	5 years	7,150.40	1,430.00	2,860.00
" —Oakland.....	1919	"	5 years	2,250.00	150.00	1,800.00
" —Studebaker.....	1921	"	5 years	1,797.30	359.46	385.66
" —Buick.....	1922	"	5 years	2,298.35	459.67	—
Furniture and Fixtures.....	1917	"	10 years	14,402.38	1,440.36	8,130.81
Dwelling House—Frame & Brick.....	1917	"	20 years	44,947.49	2,247.37	13,432.62
Business Block at Calipatria.....	1921	Six years	20 years	13,500.00	675.00	843.75
Brick Bldg. 926 So. Olive.....	1920	New	33 years	15,000.00	450.00	900.00
" " 933 So. Olive.....	1922	"	20 years	11,078.89	553.95	—
					<u>\$8,280.99</u>	

ITEM 10—OTHER INCOME:

Big Conduit Land Co.—Return over and above cost	\$21,033.00
Ramona Ranch Co. " " " "	1,130.51
San Fernando Land Co. " " " "	6,022.14
Fielding J. Stilson Recovery of bad debt.....	170.83
Title Insurance & Trust Co. Trustee—Trust S-5505	19,069.89
" " " " Trust S-4867	7,334.47
" " " " Trust S-5449	2,834.41
" " " " Trust S-3074	481.74
" " " " Trust A-4205	2,279.06
" " " " Trust A-3601	544.34
" " " " Trust S-5925	2,957.27

\$63,857.66

ITEM 23

Discount and expense on lot sales.....	\$13,366.53
Wages.....	13,506.50
Title Insurance & Trust Co. Trustee—Trust S-6067	656.44
" " " " Trust S-4846	7.38
" " " " Trust S-5975	27,764.66
" " " " Trust S-5638	9,226.22
General Expense.....	17,162.68
	<u>\$81,690.41</u>

CHANDIS SECURITIES COMPANY
Income Tax—1923

Schedule H

SCHEDULE H—DIVIDENDS DEDUCTIBLE:

SOURCE

Central Inc. Corporation.....	\$ 10.78
Cinema Finance Corporation.....	388.26
Citizens National Bank.....	803.00
Citizens Trust & Savings Bank.....	202.00
District Bond Company.....	500.00
First Nat. Bank of Los Angeles.....	1,080.00
Los Angeles Athletic Club.....	60.00
Los Angeles Morris Plan Bank.....	300.00
Mortgage Guarantee Company.....	770.00
Shell Union Oil Company.....	1,260.86
Times-Mirror Company.....	67,515.66
Union Oil Co. of California.....	94.55
Union Rock Company.....	4,800.00
L. A. Pressed Brick Company.....	20.00
Signal Mt. Land & Cattle Company.....	300.00
Misc. Alpha Omicron Pi House.....	3.50
Dividends from Tr. 3872.....	67,098.87
Dividends from 1st Nat. Bank.....	225.00
Union Rock Company (1922).....	1,200.00
	<hr/>
	146,632.48
Adjustment.....	5,356.00
	<hr/>
Total.....	<u>\$141,276.48</u>

[183]

CHANDIS SECURITIES COMPANY
Income Tax 1923

Schedule L—Line 4

LOSSES REPORTED BUT NOT APPEARING ON CORPORATE BOOKS:

Losses reported by Title Insurance & Trust Company of Los Angeles, Calif. as being sustained by Chandis Securities Company by reason of operating the following numbered tracts, in which trusts the Title Insurance & Trust Company acts as trustee and in which Chandis Securities Company has a beneficial interest.

Trust #S-6067.....	\$ 656.44
Trust #S-4846.....	7.38
Trust #S-5975.....	27,764.66
Trust #S-5638.....	9,226.22
	<hr/>
	<u>\$37,654.70</u>

Schedule L—Line 13-1

INCOME REPORTED BUT NOT APPEARING ON CORPORATE BOOKS:

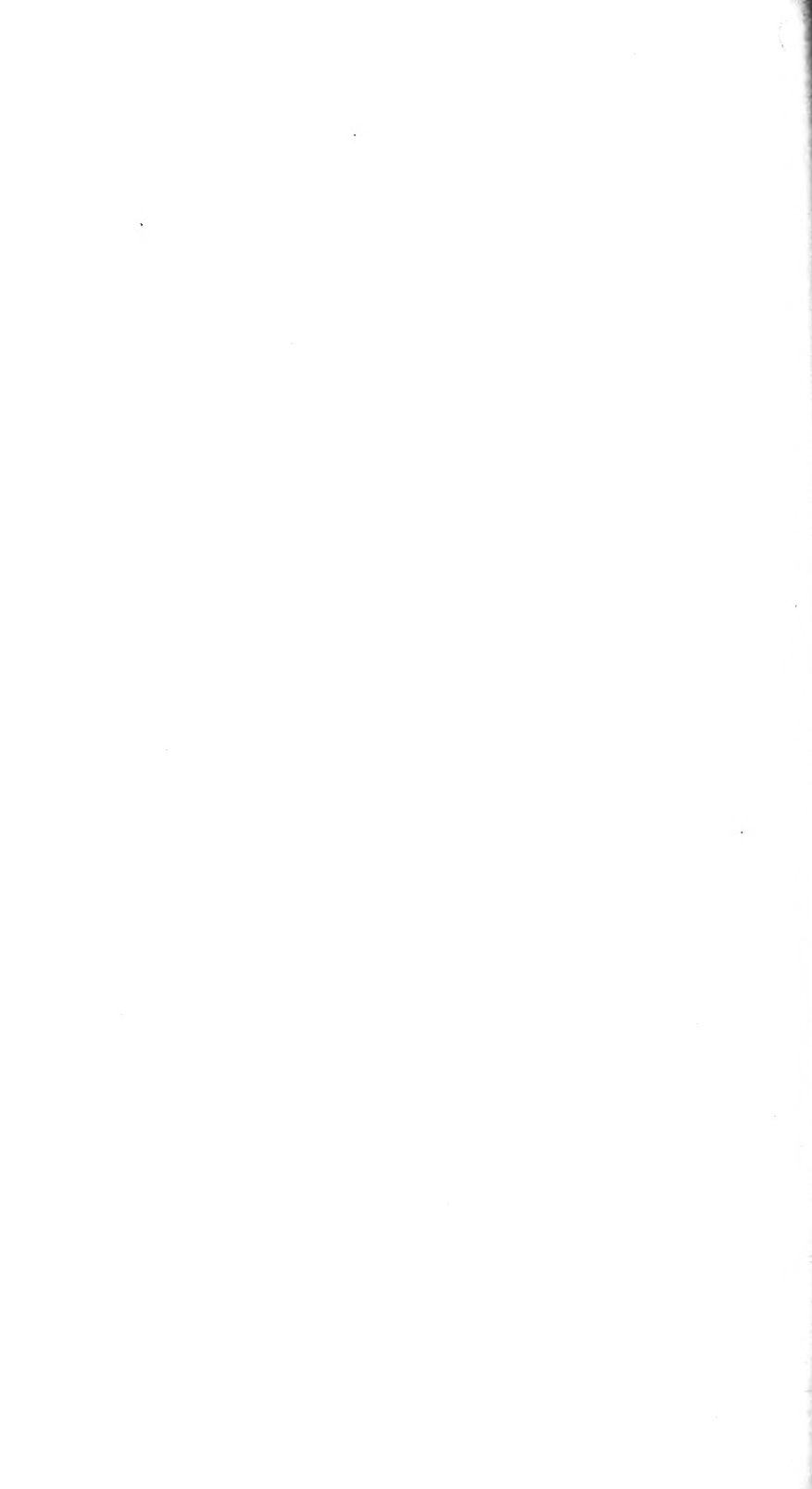
Income reported by Title Insurance & Trust Company of Los Angeles, Calif. as accruing to the Chandis Securities Company by reason of operating the following numbered trusts, in which trusts the Title Insurance & Trust Company acts as trustee and in which Chandis Securities Company has a beneficial interest.

Trust #S-5005.....	\$19,069.89
Trust #S-4867.....	7,334.47
Trust #S-3074.....	481.74
Trust #A-4205.....	2,279.06
Trust #A-3601.....	544.34
Trust #S-5925.....	2,957.27
	<hr/>
	<u>\$32,666.77</u>

Note: Additional income was reported by Title Insurance & Trust Company as accruing to Chandis Securities Company in a total sum of \$7,261.38, in Trusts A-636—A-687—A-762—A-5441—A-5814.

The foregoing sum has been received by Chandis Securities Company and is reported and included in the "Interest" receipts in this return.

[184]



Rec'd copy of within affidavit on April 6, 1940
at 10:55 A. M.

COSGROVE & O'NEIL
F. B. YOAKUM, JR.
A. CALDER MACKAY
By F. B. YOAKUM, JR.

[Endorsed]: Filed Apr. 6, 1940. [185]

At a stated term, to wit: The February Term,
A. D. 1940 of the District Court of the United
States of America, within and for the Central Di-
vision of the Southern District of California, held
at the Court Room thereof, in the City of Los An-
geles on Monday the 8th day of April in the year
of our Lord one thousand nine hundred and forty.
Present:

The Honorable: Leon R. Yankwich, District
Judge.

[Title of Cause.]

This cause coming on for hearing motion to quash
order for production of records; A. Calder Mackay,
Esq., appearing as counsel for the defendant:

On motion of Attorney Mackay it is ordered that
the cause be, and it hereby is, continued to April
22, 1940, at 2 o'clock P. M. for the said hearing;
return date on the Order to produce being contin-
ued to the same date. [186]

[Title of District Court and Cause.]

AFFIDAVIT OF H. E. DOWNING

State of California

County of Los Angeles—ss.

H. E. Downing, being first duly sworn, deposes and says: That he is the H. E. Downing named as one of the respondents in the above entitled case.

That neither on or about September 15, 1931, nor at any time did affiant tell Charles W. Donnally, Internal Revenue Agent, that the notes of the Chandis Securities Company held by Mrs. Marian Otis Chandler and her children had been cancelled in 1929;

That neither on or about September 15, 1931, nor at any time did affiant tell said Internal Revenue Agent that if said notes were found, they would indicate on their face that they were cancelled in 1929; that neither on or about September 15, 1931, nor at any time did affiant tell said Internal Revenue Agent that a former bookkeeper was responsible for misplacing the said notes.

That it is not true that Agent Donnally repeatedly requested affiant to produce said notes. Affiant has no recollection that said agent ever requested affiant to produce said notes. It is not true that affiant repeatedly, or at all, told said Agent that said notes had been misplaced. It is not true that affiant repeatedly, or at all, told Agent Donnally that affiant was unable to produce said notes.

[187]

That affiant in the proceedings before the United States Board of Tax Appeals of Mrs. Marian Otis Chandler and her children for the year 1929 (which proceedings were held in Long Beach on the 5th day of October, 1933) testified on cross examination, conducted by the Commissioner's counsel, in part as follows:

"Q. Do you know Revenue Agent Donnally?

"A. Yes, I do.

"Q. This is Mr. Donnally sitting here?

"A. Yes.

"Q. I will ask you if you did not inform him in October, 1931, that those notes were cancelled in 1929?

"A. No, sir, I did not.

"Q. You did not so inform him?

"A. No."

That during the hearing in said proceedings before the United States Board of Tax Appeals Revenue Agent Donnally was in the court room assisting the Government counsel in the presentation of the Commissioner's case; that prior to said hearing Revenue Agent Donnally checked the stipulation submitted and filed with the Board of Tax Appeals in these matters; that Revenue Agent Donnally did not take the stand in said proceedings or give any testimony in the matter.

That at or about the time Agent Donnally made his investigation of the books and records of Chandis Securities Company in connection with the income tax return of Mrs. Marian Otis Chandler for

the year 1929 said Agent, as affiant verily believes, made an investigation of the income tax return of Chandis Securities Company for the year 1929; that the income tax return of Chandis Securities Company for the year 1929 contains a balance sheet of Chandis Securities Company for the year ending December 31, 1929, which balance sheet discloses outstanding capital stock of \$500,000.00 par value, and also discloses that the principal and accrued interest of said notes were then liabilities of the Chandis Securities Company.

That the books of the Chandis Securities Company contained appropriate entries to show that the transaction was not consummated in 1929; and that the stock issued for the principal and accrued interest of the notes and its old stock was not issued until 1930. [188]

That in view of the foregoing and the knowledge of Agent Donnally that the notes and the interest at the close of 1929 were outstanding liabilities of the Chandis Securities Company it was impossible for Agent Donnally to have relied upon the alleged statements which are herein denied.

Affiant states that it is not impossible without an examination of the books and records of the Chandis Securities Company from 1916 to 1930 to determine how much of the face amounts of the notes actually represents interest and how much principal, and that it is not impossible to determine how much interest Mrs. Marian Otis Chandler should have reported in her income tax return for 1930 in the event that she realized a taxable gain on account of

the exchange of her notes plus accrued interest for stock.

Affiant further denies that in order to determine the interest income of Mrs. Marian Otis Chandler for 1930 it is necessary to determine the value of the stock which she received in that year in exchange for the notes and accrued interest.

Affiant further states that it is not necessary in order to determine the value of said stock, to determine when the assets of the corporation behind the stock were acquired or the manner in which they were acquired, or from whom they were acquired.

Affiant further states that the Commissioner under date of December 13, 1929 issued his notice of final determination of additional tax liability of Mrs. Marian Otis Chandler for the years 1924, 1925 and 1926 wherein he added to her income the interest which had been accrued by the Chandis Securities Company for the years involved but which was not paid to her, his determination being upon the theory that she had constructively received said interest; that an appeal was taken to the United States Board of Tax Appeals from this determination.

Affiant further states that the Commissioner under date of July 21, 1931 issued his notice of final determination of additional tax liability of Mrs. Marian Otis Chandler for the year 1927 wherein he added to her income the interest which had been accrued by the Chandis Securities Company for the year involved but which was not paid to her,

his determination being upon the theory that she had constructively received said interest; that an appeal was taken to the United States Board of Tax Appeals from this determination. [189]

That thereafter and during the year 1932, pursuant to a stipulation of the Commissioner and representatives of Mrs. Marian Otis Chandler, the Board entered its orders of no deficiencies in the appeals referred to herein.

That the Commissioner by letter dated December 11, 1931 proposed a deficiency against Mrs. Marian Otis Chandler for the year 1928, the proposed deficiency being based upon the theory of constructive receipt by her of interest accrued by the Chandis Securities Company for that year on the notes held by her.

H. E. DOWNING

Subscribed and sworn to before me this 19 day of April, 1940.

[Seal]

C. O. DENNING

Notary Public in and for said County and State.

Received copy of the within this.....day of.....
4/19/40.

SAMUEL TAYLOR

[Endorsed]: Filed Apr. 19, 1940. [190]

At a stated term, to wit: The February Term, A. D. 1940 of the District Court of the United States of America, within and for the Central Di-

vision of the Southern District of California, held at the Court Room thereof, in the City of Los Angeles on Monday the 22nd day of April in the year of our Lord one thousand nine hundred and forty.

Present:

The Honorable: Leon R. Yankwich, District Judge.

[Title of Cause.]

This cause coming on for hearing motion to quash order for production of records; Eugene Harpole and Samuel Taylor, Attorneys, Bureau of Internal Revenue, appearing as counsel for the plaintiff; and F. B. Yoakum, Jr., Esq., appearing as counsel for the Movants:

It is ordered that return date on order to produce documents be, and it hereby is, continued to May 6, 1940, at 10 o'clock A. M. [192]

[Title of District Court and Cause.]

AFFIDAVIT OF CHARLES W. DONNALLY

State of California

County of Los Angeles—ss.

Charles W. Donnally, being first duly sworn, deposes and says:

1. That he has read the affidavit of H. E. Downing, executed on the 19th day of April, 1940.

2. That he refers to and incorporates by reference the affidavit he (Charles W. Donnally) exe-

cuted on the 5th day of April, 1940, a copy of which is on file with the records of this proceeding, and that he re-affirms each and every statement made therein.

3. That the following excerpts are taken from the Official Report of Proceedings before the United States Board of Tax Appeals in the cases of *Marian Otis Chandler, et al, v. Commissioner of Internal Revenue* (which proceedings were held in Long Beach on the 5th of October, 1933, and which proceedings are referred to on page 2 of said affidavit of Mr. Downing): [193]

(Unless otherwise indicated, the questions are by Mr. Leming, counsel for the Commissioner, and the answers are by Mr. Downing.)

“Q. Do you know Revenue Agent Donally?

“A. Yes, I do.

“Q. This is Mr. Donally sitting here?

“A. Yes.

“Q. I will ask you if you did not inform him in October, 1931, that those notes were cancelled in 1929? A. No, sir, I did not.

“Q. You did not so inform him?

“A. No.

“Q. Didn't you inform him at that time that they were in your possession in the year 1929? A. I don't remember.

“Q. You would not want to say, then, that you did or did not so inform him?

“A. That they were in my possession?

“Q. Yes.

“A. I will say that I do not remember that I so informed him.

“Q. Were they in your possession at any time in the year 1929? A. Yes.

“Q. They were? A. They were.

“* * * * * *

“Q. I will ask you, Mr. Downing, if you did not tell Revenue Agent Donnally in October, 1931, that exchange of stock for the indebtedness took place in the year 1929, and the notes were cancelled in the [194] year 1929, and the physical issuance of the stock certificates simply was a mechanical action which was delayed because you did not have the certificates printed?

“A. I have no recollection of that conversation with Mr. Donnally.

“Q. You have no recollection of telling him that the only reason the certificates were not issued in 1929 was because the printer had not printed them? A. Why, no.

“Q. You did not tell him that?

“A. I have no recollection of telling him that. The stock certificates, if I may say so, are the same certificates which we had previously. The books will show that.

“Q. When did you have the certificates printed to take care of the issuance of the new stock?

“A. They were not printed. They are the same certificates.

“Q. Did they come out of the same stock certificate book? A. Absolutely, yes, sir.

“Q. Did you tell Mr. Donnally then that all that remained to do was the physical, mechanical issuance of those certificates?

“A. I have no such recollection.

“Q. Assuming I am mistaken, Mr. Downing, as to how he said that, I want to be clear with you on this point: Didn't you tell him that nothing remained to be done in 1929 but the mechanical issuance of the stock certificates?

[195]

“A. I have no recollection of telling him that.

“Q. Well, if Mr. Donnally says that is what you did tell him, what would you say to that?

“A. I probably should not say anything to it.

“Q. Because you have no recollection about it; is that right?

“A. I have no recollection of telling him any such thing.

“* * * * *

“Q. (By Mr. Mackay) Mr. Downing, how do you account for the fact that the certificates in the same book are—that the certificates from 29 on are different than prior to 28?

“A. That was occasioned by the application of economy, and it was occasioned, or, rather, it was arrived at, as I say, by the addition of ciphers and the putting in of commas and periods.

“Q. (by Mr. Mackay) Do you call that an overprint?

“A. That is what we call an overprint, yes.

“Q. (by Mr. Mackay) Do you know when that was done?

“A. I cannot tell you definitely. It was just a part of the mechanics and I cannot tell you when it was done definitely.

“* * * * *

“Cross Examination

“By Mr. Leming:

“Q. In other words, you had some new certificates printed; is that right?

“A. No, sir.

“Q. All right. What did you have printed? Let us use the word ‘print’. I assume there was a print by a printing press, was there not?

[196]

“A. There was not.

“Q. How was it done?

“A. Pen and ink.

“* * * * *

“Q. I want to ask you again if you did not tell Mr. Donnally that it was not done in 1929, and that is the reason there was a delay in the mechanics of issuing these certificates?

“A. I have no recollection of that conversation with Mr. Donnally.

“Q. Do you know whether this was done in 1929 and 1930? A. I do not.

“Q. You would not undertake to say whether it was done in 1929 or 1930?

“A. I would not.

“Q. But it had to be done before you issued the certificates; is that right?

“A. Yes, sir.

“* * * * *

“Mr. Leming: If your Honor please, in view of the questions I have asked the witness and his recollection does not permit him to answer, I am prepared to let Mr. Donnally testify to those conversations.

“I know the rule ordinarily is, so far as impeachment is concerned—you understand I am not trying to reflect any upon Mr. Downing, at least further than his recollection, and ordinarily I think that if a witness denies a statement it is proper to impeach him. It is not clear in my own mind about putting on a witness where the one on the stand merely does not remember whether there was such a conversation or not.

[197]

“I am stating my limited knowledge about that situation with this thought, if your Honor thinks the witness should not testify, I would not insist, but I should like to put him on the stand and let him say what that conversation was.

“The Member: There has been nothing by way of principal added to what was presented this morning. You are calling for the production of a witness for impeachment. There were certain matters testified to this morning, as to

which the witness claimed no recollection and as to which I gathered from questions propounded by the government counsel that Mr. Donnally had a different view. But government counsel did not choose to put him on this morning, and I wonder if he has not foregone the right.

“Mr. Leming: Well, I really think it rather material. I would not insist upon it one way or the other, but it occurs to me at this time, since the witness has such a total lack of recollection as to the time of printing that conversation might be material.

“The member: I think we should let the record stand as it is.

“Mr. Leming: That is agreeable.

“Mr. Mackay: That is all, your Honor.”

CHARLES W. DONNALLY

Subscribed and sworn to before me this 2 day of May, 1940.

[Seal]

T. G. ALBRIGHT

Notary Public in and for the County of Los Angeles, State of California.

My commission expires October 22, 1940.

Rec'd copy of within May 3, 1940.

A. CALDER MACKAY

By F. B. YOAKUM, JR.

[Endorsed]: Filed May 3, 1940. [198]

[Title of District Court and Cause.]

AFFIDAVIT OF WARNER E. WILLIAMS.

Warner E. Williams, being duly sworn, deposes and says:

Section 11 of the Revenue Act of 1928 provides that there shall be levied, collected and paid for each taxable year upon the net income of every individual certain taxes. Section 21 of the same Act defines net income as gross income computed under Section 22 less deductions allowed by Section 23. Section 22(a) provides, among other things, that any individual, required by law to file a return, receiving interest derived from any source whatever shall report it on the income tax return provided by law. Section 51 requires that every individual having a gross income of \$5,000.00 or over, regardless of the amount of his net income, shall make, under oath, a return, stating specifically the items of his gross income and the deductions and credits allowed.

Affiant is familiar with the 1930 income tax return of Marian Otis Chandler. A true and correct photostatic copy of said return is incorporated as Exhibit 7 to the Affidavit heretofore [200] executed by affiant on April 6, 1940, and on file in this proceeding and is herein incorporated by reference in this Affidavit.

In the year 1930 Marian Otis Chandler received interest in the approximate amount of \$661,000.00 from the Chandis Securities Company in the form of stock of that corporation. As a result of the receipt of such interest she became liable for a tax

of a considerable sum in addition to the tax liability revealed in her return for the year 1930. She failed to report any part of this interest income in the income tax return filed by her for that year, nor did she make any disclosure of any sort in that income tax return that any such item had been received. Representatives of the Bureau of Internal Revenue, including the affiant, have a strong suspicion that the taxpayer's failure to report or disclose this interest income item was due to a deliberate, willful and fraudulent attempt to evade the tax thereon. The definitely known facts giving rise to this suspicion of fraud are set forth in the affidavits, and exhibits thereto, heretofore filed on behalf of the petitioner in this proceeding. It is necessary to examine the books and records of the Chandis Securities Company in order to determine definitely whether or not Marian Otis Chandler committed a fraud in connection with her 1930 income tax return.

WARNER E. WILLIAMS

Subscribed and sworn to before me this 9 day of May, 1940.

[Seal]

T. G. ALBRIGHT,

Notary Public in and for the County of Los Angeles, State of California.

My commission expires October 22, 1940.

Rec'd copies of within this 10th day of May, 1940.

F. B. YOAKUM, JR.,

A. CALDER MACKAY,

By F. B. YOAKUM, JR.

[Endorsed]: Filed May 10, 1940. [201]

[Title of District Court and Cause.]

COUNTER-AFFIDAVIT OF H. E. DOWNING

State of California,

County of Los Angeles—ss.

H. E. Downing, being duly sworn, deposes and says:

I have carefully read the affidavit of Warner E. Williams dated May 9, 1940. It is not true that in the year 1930 Marian Otis Chandler received interest in the approximate amount of \$661,000.00 from Chandis Securities Company. It is true that during said year Marian Otis Chandler received stock of said corporation which was given by said corporation and accepted by Marian Otis Chandler in satisfaction of accrued interest owing from the corporation to Marian Otis Chandler in the approximate amount of \$661,000.00, in the manner more particularly described in my affidavit of March 19, 1940, said affidavit being made a part of the Notice of Motion to Quash.

It is not true that as a result of the receipt of said stock Marian Otis Chandler became liable for a tax of a considerable or any sum in addition to the tax liability revealed [203] in her return for the year 1930. It is not true that Marian Otis Chandler failed to report any part of her income in the income tax return filed by her for the year 1930. In this connection affiant avers that Marian Otis Chandler was not required to make any disclosure in her income tax return for the year 1930

that she had accepted stock of Chandis Securities Company in exchange for the principal and accrued interest thereon owing by Chandis Securities Company to Marian Otis Chandler.

It is not true that it is necessary to examine the books and/or records of Chandis Securities Company in order to determine whether Marian Otis Chandler committed a fraud in connection with her 1930 income tax return.

H. E. DOWNING

Subscribed and sworn to before me this 14 day of May, 1940.

[Notarial Seal]

C. O. DENNING,

Notary Public in and for the County of Los Angeles, State of California.

Receipt of a copy of the within is hereby admitted this 14th day of May, 1940.

EUGENE HARPOLE,

Attorney for Petitioner.

[Endorsed]: Filed May 14, 1940. [204]

[Title of District Court and Cause.]

MINUTE ORDER

The Motion of the Respondents to quash the Order for Production of Records, dated March 5, 1940, heretofore submitted, is now decided as follows.

The Motion is granted. The Order is quashed and annulled without prejudice, however, to a new ap-

[Title of District Court and Cause.]

COUNTER-AFFIDAVIT OF H. E. DOWNING

State of California,

County of Los Angeles—ss.

H. E. Downing, being duly sworn, deposes and says:

I have carefully read the affidavit of Warner E. Williams dated May 9, 1940. It is not true that in the year 1930 Marian Otis Chandler received interest in the approximate amount of \$661,000.00 from Chandis Securities Company. It is true that during said year Marian Otis Chandler received stock of said corporation which was given by said corporation and accepted by Marian Otis Chandler in satisfaction of accrued interest owing from the corporation to Marian Otis Chandler in the approximate amount of \$661,000.00, in the manner more particularly described in my affidavit of March 19, 1940, said affidavit being made a part of the Notice of Motion to Quash.

It is not true that as a result of the receipt of said stock Marian Otis Chandler became liable for a tax of a considerable or any sum in addition to the tax liability revealed [203] in her return for the year 1930. It is not true that Marian Otis Chandler failed to report any part of her income in the income tax return filed by her for the year 1930. In this connection affiant avers that Marian Otis Chandler was not required to make any disclosure in her income tax return for the year 1930

that she had accepted stock of Chandis Securities Company in exchange for the principal and accrued interest thereon owing by Chandis Securities Company to Marian Otis Chandler.

It is not true that it is necessary to examine the books and/or records of Chandis Securities Company in order to determine whether Marian Otis Chandler committed a fraud in connection with her 1930 income tax return.

H. E. DOWNING

Subscribed and sworn to before me this 14 day of May, 1940.

[Notarial Seal] C. O. DENNING,
Notary Public in and for the County of Los Angeles, State of California.

Receipt of a copy of the within is hereby admitted this 14th day of May, 1940.

EUGENE HARPOLE,
Attorney for Petitioner.

[Endorsed]: Filed May 14, 1940. [204]

[Title of District Court and Cause.]

MINUTE ORDER

The Motion of the Respondents to quash the Order for Production of Records, dated March 5, 1940, heretofore submitted, is now decided as follows.

The Motion is granted. The Order is quashed and annulled without prejudice, however, to a new ap-

plication upon a new petition and a proper showing limited in point of time and "to matters required to be included in the return" of Marian Otis Chandler, with special reference to the particular transaction which is under investigation.

Dated this 10th day of June, 1940.

Opinion filed. [206]

[Title of District Court and Cause.]

MEMORANDUM OPINION

Appearances:

For the Petitioner:

BEN HARRISON,

United States Attorney.

E. H. MITCHELL,

Asst. U. S. Attorney.

EUGENE HARPOLE,

Special Attorney,

Bureau of Internal Revenue.

SAMUEL TAYLOR,

Special Attorney,

Bureau of Internal Revenue.

For the Respondents:

COSGROVE & O'NEIL,

F. B. YOAKUM, JR.,

A. CALDER MACKAY,

Los Angeles, California. [207]

Yankwich, District Judge:

On March 5, 1940, the petitioner, George D. Martin, as Internal Revenue Agent, in charge of the Sixth Internal Revenue District of California, filed

a petition for production of records, under Section 3614 of the Internal Revenue Code.

The petition recited these facts:

Chandis Securities Corporation is a California corporation. E. H. Downing is its Assistant Secretary in charge of its records. Marian Otis Chandler is the Secretary of the Corporation and the maker of an individual federal income tax return for the year 1930, which is under investigation.

The Respondents have in their custody records bearing upon matters required to be included in Marian Otis Chandler's tax return for the year 1930.

On November 30, 1939, the petitioner served a summons upon the respondents requiring them to appear before him on the 11th day of December, 1939, to give testimony relating to the tax liability of Marian Otis Chandler for the named year and to bring with them the following papers:

“Records of Chandis Securities Company for the years 1916 to 1930, inclusive, as follows: Minute Books; capital stock certificate books, ledgers and journals; all accounting books and records including general ledgers, journals, cash books, auxiliary registers and ledgers, together with all vouchers, correspondence and other written data supporting the original entries in said accounting books; all promissory notes of Chandis Securities Company issued, assigned, endorsed, or otherwise transferred during said years to Marian Otis

corporation* for the years 1916 to 1930, when the only issue involved in the tax liability of one of its stockholders, Marian Otis Chandler, for the year 1930, by reason of a single transaction, *long known to the Government* and to the agents of the Bureau of Internal Revenue.

There is no showing that such records, *over this long period of years*, “bear upon the matters required to be included in the return” (Internal Revenue Code, Sec. 3614) of Marian Otis Chandler for the year 1930.

The agents are not the sole judges as to the scope of the examination.

They must satisfy the Court that what they seek may be *actually needed*. Otherwise, they would be assuming inquisitorial powers beyond the scope of the statute. [210]

The grounds just given embody the principles governing cases of this character. (McDonough v. Lambert, 1 Cir., 1938, 94 F(2) 838, 841; McMann v. Securities & Exchange Com., 2 Cir., 1937, 87 F(2) 377; 379; Newfield v. Ryan, 5 Cir., 1937, 91 F(2) 700, 703; Zimmerman v. Wilson, 3 Cir., 1939, 105 F(2) 583, 585; In re Keegan, D. C. N. Y. 1937, 18 Fed. Sup. 746; In re Andrews Tax Liability, D. C. Md., 1937, 18 Fed. Sup. 804, 807; see also, Miles v. United Founders Corp., D. C. N. J., 1933, 5 Fed. Sup. 413, *involving an exchange of stock* where the order was *properly* limited to

“all books, papers, and other memoranda *pertaining to the exchange of stock* of American

*Italics in this Opinion are by the Court.

Founders Corporation (a Maryland corporation) for that of United Founders Corporation (a Maryland corporation).” (Italics are by the Court)

The fact that the corporation is a “family corporation” does not subject it to different rules.

Its existence as a legal entity over a long period of years is not challenged.

Nor is it charged that it was organized fraudulently or for the purpose of tax evasion.

For the foregoing reasons, the Motion of the Respondents to quash the order for production of records is hereby granted. The order is quashed and annulled without prejudice, however, to a new application upon a new petition and a proper showing limited in point of time and “to matters required to be included in the return” of Marian Otis Chandler, with special reference to the particular transaction which is under investigation.

Dated this 10th day of June, 1940.

LEON R. YANKWICH,
United States District Judge.

[Endorsed]: Filed Jun. 10, 1940. [211]

[Title of District Court and Cause.]

NOTICE OF APPEAL TO THE CIRCUIT
COURT OF APPEALS

Notice is hereby given that George D. Martin, as Internal Revenue Agent in Charge for the Sixth

United States Internal Revenue Collection District of California, the petitioner in the above entitled proceeding, hereby appeals to the Circuit Court of Appeals for the Ninth Circuit from the order of the United States District Court for the Southern District of California granting the motion of the respondents in the above entitled proceeding to quash the order for production of records dated March 5, 1940. Said order granting the motion to quash was made and entered in the above entitled action through Honorable Leon R. Yankwich, Judge of the above entitled Court, on the 10th day of June, 1940.

WM. FLEET PALMER,

U. S. Attorney,

E. H. MITCHELL,

Asst. U. S. Attorney,

EUGENE HARPOLE,

Special Attorney, Bureau of
Internal Revenue,

SAM TAYLOR,

Special Attorney, Bureau of
Internal Revenue.

By SAMUEL TAYLOR,

Attorneys for Appellant.

Address: New Post Office and Courthouse Bldg.,
Los Angeles, California.

Copy mailed Sept. 6, 1940 to A. Calder Mackay,

T. B. Cosgrove, F. J. O'Neil and F. B. Yoakum,
Jr., attys. for respondents.

R. S. ZIMMERMAN,

Clerk.

By E. L. S.,

Deputy Clerk.

[Endorsed]: Filed Sep. 6, 1940. [213]

[Title of District Court and Cause.]

ORDER EXTENDING TIME TO DOCKET
CAUSE ON APPEAL AND FOR PREPA-
RATION OF RECORD ON APPEAL

Good cause appearing therefor, It Is Hereby Or-
dered that the time within which to file the record
and docket the above-entitled cause in the United
States Circuit Court of Appeals for the Ninth Cir-
cuit be, and the same hereby, is extended to and
including December 5, 1940.

Dated this 4th day of Oct., 1940.

PAUL J. McCORMICK,

United States District Judge.

[Endorsed]: Filed Oct. 4, 1940. [215]

[Title of District Court and Cause.]

STATEMENT OF POINTS ON APPEAL

To Chandis Securities Company and H. E. Downing, Respondents and Appellees, and to their Attorneys Cosgrove & O'Neil, F. B. Yoakum, Jr., A. Calder Mackay:

You and each of you will please take Notice under the provisions of Rule 75 (a) of the Rules of Civil Procedure for the United States District Courts that the Petitioner and Appellant intends to rely upon the following points in the appeal of the above-entitled case:

I.

The Court erred in quashing and annulling its Order made on March 5, 1940, for the production of records.

II.

The Court erred in sustaining Respondent's Motion to Quash the Order of the Court made on March 5, 1940, for the production of records.

III.

The Court erred in permitting the respondents, [216] whose tax liability is not before the Court in this proceeding, to raise any question as to the necessity for the petitioning Revenue Agent to make a further examination or to examine the books of the Chandis Securities Company, or to require the testimony of H. E. Downing, the assistant secretary of Chandis Securities Company,

in connection with the income tax liability of Marion Otis Chandler for the calendar year 1930.

IV.

The Court erred in permitting the respondents to raise any question in this proceeding as to whether or not Marion Otis Chandler, a party not before the Court, was actually liable for an additional income tax for the calendar year 1930.

V.

The Court erred in permitting the respondents to raise the question as to whether the books and records sought by the Revenue Agent were actually needed in order to determine the tax liability of Marion Otis Chandler, a party not before the Court, for the taxable year 1930.

VI.

The Court erred in holding that the petition for the production of records and the affidavits and exhibits filed in support thereof did not allege facts sufficient to show reasonable grounds for suspicion of fraud or probable cause for the examination of the books and records requested to ascertain if there had been fraud in connection with the income tax return filed by Marion Otis Chandler for the calendar year 1930. [217]

VII.

The Court erred in holding that the Revenue Agent must allege facts showing that fraud existed

in connection with the filing of the 1930 Federal income tax return of Marion Otis Chandler in order to obtain the books and records of Chandis Securities Company for the purpose of ascertaining whether facts showing such fraud were to be found in said books and records.

VIII.

The Court erred in holding that the order for production of books and records of the Chandis Securities Company for the purpose of ascertaining whether Marion Otis Chandler committed a fraud against the revenue in the filing of her 1930 income tax return was insufficiently limited in time and in the number and scope of books and records requested.

Dated: This 31st day of December, 1940.

WM. FLEET PALMER,
United States Attorney.

E. H. MITCHELL,
Assistant United States Atty.

EUGENE HARPOLE,
Special Attorney, Bureau of
Internal Revenue.

SAMUEL TAYLOR,
Special Attorney, Bureau of
Internal Revenue.

By: EUGENE HARPOLE,
Attorneys for Appellant.

Receipt of a copy of the foregoing Statement of Points is acknowledged this day of, 1941.

..... [218]

.....

.....

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.....

By:

Attorneys for Appellees.

Received copy of the within Statement, etc. this 31st day of Dec. 1940.

F. B. YOAKUM, JR.,

A. CALDER MACKAY,

Attorneys for Respondents.

[Endorsed]: Filed Dec. 31, 1940. [219]

[Title of District Court and Cause.]

CERTIFICATE OF CLERK

I, R. S. Zimmerman, Clerk of the District Court of the United States for the Southern District of California, do hereby certify the foregoing pages, numbered from 1 to 226, inclusive, contain full, true and correct copies of Petition for Production of Records with Exhibits A to D; Order for Production of Records; Order Continuing Return Date of Order; Order Continuing Return Date of Order; Notice of Motion to Quash Order for Production

of Records with Affidavit of H. E. Downing and Exhibits 1 to 8; Affidavits of Charles W. Donnally; Affidavit of Warner E. Williams and Exhibits 1 to 9; Order Continuing Hearing to April 22, 1940; Affidavit of H. E. Downing; Order Continuing Hearing to May 6, 1940; Affidavit of Charles W. Donnally; Affidavit of Warner E. Williams; Counter Affidavit of H. E. Downing; Order of June 10, 1940; Memorandum Opinion; Notice of Appeal; Appellant's Designation of Record on Appeal; Order Extending Time to Docket Record on Appeal; Statement of Points on Appeal; Appellee's Designation of Additional Record; which together with the original exhibits* transmitted herewith constitute the record on appeal to the United States Circuit Court of Appeals for the Ninth Circuit.

Witness my hand and the Seal of the District Court of the United States for the Southern District of California, this 29th day of January, A. D. 1941.

[Seal]

R. S. ZIMMERMAN,

Clerk,

By EDMUND L. SMITH,

Deputy.

*[Printer's Note: Respondent's Exhibit A and Petitioner's and Appellant's Exhibit 1 are set out at pages 165 to 256 following.]

RESPONDENT'S EXHIBIT A

United States Board of Tax Appeals

Docket No. 67468

MARIAN OTIS CHANDLER,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

[Excerpts from Transcript of Record in the Above
Entitled Case.]

[Title of Court and Cause.]

FIRST AMENDED PETITION.

Comes now the Petitioner and having first obtained leave of the Board files this as her First Amended Petition appealing from the determination of the Respondent set forth in his deficiency letter dated July 1, 1932, symbols IT:AR:E-1, NF-60D, and as the basis of this proceeding alleges as follows:

(1) The Petitioner is an individual residing in the City of Los Angeles, State of California, whose business address is Times Building, Los Angeles, California.

(2) The notice of deficiency, copy of which is attached to the original petition, was mailed to the Petitioner on or about July 1, 1932.

(3) The taxes in controversy are income taxes for the calendar year 1929 and in the sum of \$163,175.03.

(4) The determination of tax set forth in the said notice of deficiency is based upon the following errors:

(a) The Respondent has erroneously increased net income by the sum of \$661,369.56.

(b) Respondent has erroneously and illegally determined that Petitioner realized income in the sum of \$661,369.56 in a transaction whereby Petitioner exchanged certain notes owned by her and executed by the Chandis Securities Company, a corporation, together with accrued interest due upon said notes for stock in the said Chandis Securities Company and failed to treat the transaction as a non-taxable transaction within the meaning of the provisions of the Revenue Act of 1928.

(c) Respondent has erroneously and illegally determined that certain stock in the Chandis Securities Company received by the Petitioner in exchange for certain notes of the said Company owned by her together with accrued interest thereon had a market value equal to the par value of the stock so received. The stock did not have a market value in excess of 50 per cent of its par value.

(d) The alleged gain or income which the Respondent is attempting to tax for the year 1929, does not constitute taxable income within the meaning of the provisions of the Revenue Act of 1928, and/or the Sixteenth Amendment to the Constitution of the United States.

(e) The Respondent's action in determining that the gain, if any, realized by Petitioner on account of the surrender by her of promissory notes for stock in the Chandis Securities Company was erroneous and illegal since Petitioner did not, during the year 1929, surrender her notes or receive said stock.

(5) The facts upon which the Petitioner relies as a basis of this proceeding are as follows:

(a) Petitioner's books of account have at all times been kept upon the cash receipts and disbursement basis and her income tax return for the year 1929 was prepared and filed on said basis.

(b) Petitioner owned certain notes executed by the Chandis Securities Company, a corporation, aggregating in principal the sum of \$810,687.06. Interest had accrued upon Petitioner's interest in said notes to December 31, 1929, aggregating the sum of \$661,369.56.

(1) The total of the notes executed by the Chandis Securities Company, a corporation, together with the accrued interest thereon of which the sum set forth in (b) above represents a part owned by the Petitioner and her children is as follows:

	Note Principal	Accrued Interest to Dec. 31, 1929	Total
Marian Otis Chandler (Petitioner).....	\$ 810,687.06	\$ 661,369.56	\$1,472,056.62
Franceska Chandler Kirkpatrick.....	179,490.04	148,525.02	328,015.06
May Chandler Goodan.....	179,490.04	148,525.01	328,015.05
Helen Chandler.....	130,474.68	103,866.62	234,341.30
Philip Chandler.....	130,474.68	103,866.62	234,341.30
Ruth Chandler Williamson.....	130,474.69	103,866.62	234,341.31
Harrison Gray Chandler.....	130,474.68	103,866.62	234,341.30
Constance Chandler.....	130,474.70	103,866.63	234,341.33
Norman Chandler.....	116,508.03	99,305.58	215,813.61
Total.....	\$1,938,548.60	\$1,577,058.28	\$3,515,606.88

(2) The Chandis Securities Company was incorporated during the year 1916 with an authorized capital stock of \$500,000.00, divided into 500 shares of a par value of \$1,000.00 each, which stock, prior to the Company acquiring the notes hereinbefore mentioned in the manner hereinafter set forth, was issued as follows:

	Number of Shares
Marian Otis Chandler (Petitioner).....	200
Franceska Chandler Kirkpatrick.....	35
May Chandler Goodan.....	35
Helen Chandler	35
Philip Chandler	35
Ruth Chandler Williamson.....	35
Harrison Gray Chandler.....	35
Constance Chandler	35
Norman Chandler	35
Harry Chandler	20
	<hr/> 500

(3) The Chandis Securities Company realizing its inability to pay the notes and accrued interest mentioned in paragraph (b) (1) above, secured the consent of the noteholders to a plan whereby the said company would increase its capital stock to five million dollars, divided into 50,000 shares of the par value of \$100.00 each and thereafter acquire from the said noteholders their notes and the accrued interest thereon by the issuance of one share of its stock of the par value of \$100.00 per share for each \$100.00 of note principal, and accrued interest.

(4) The Chandis Securities Company in fur-

therance of the above plan, increased its capital stock to five million dollars, divided into 50,000 shares of the par value of \$100.00 each and issued to the Petitioner and the other noteholders, one share of its stock (par value \$100.00) for each \$100.00 of note principal and accrued interest.

(5) The Chandis Securities Company during the year 1930 issued to its stockholders 10 shares of the new stock of the par value of \$100.00 per share for each share of the old stock having a par value of \$1,000.00.

(6) The stock of the Chandis Securities Company was not issued during the year 1929, neither was it received by Petitioner during said year. Petitioner did not surrender her promissory notes, nor did she receive anything therefor until after the close of the year 1929. Consequently no part of the sum of \$661,369.56 constitutes taxable income within the meaning of the provisions of the Revenue Act of 1928 or the Sixteenth Amendment to the Constitution of the United States of America.

(7) In completion of the foregoing plan, the stock of the Chandis Securities Company was issued for note principal and accrued interest and in exchange for the old stock (with fractional shares being paid for in cash) and immediately thereafter the stock was issued and outstanding as follows:

Name	Notes and Interest to Dec. 31, 1929	Shares in Exchange for Notes	Cash for Frac- tional Share	Total Shares Out- standing	Issue of Stock for Stock	Total Shares Out- standing
Marian Otis Chandler.....	\$1,472,056.62	14,720	\$ 43.38	14,721	2,000	16,721
Franceska Chandler Kirkpatrick.....	328,015.06	3,280	84.94	2,344	350	3,631
May Chandler Goodau.....	328,015.05	3,280	84.95	2,344	350	3,631
Helen Chandler	234,341.30	2,343	58.70	2,344	350	2,694
Philip Chandler	234,341.30	2,343	58.70	2,344	350	2,694
Ruth Chandler Williamson.....	234,341.31	2,343	58.69	2,344	350	2,694
Harrison Gray Chandler.....	234,341.30	2,343	58.70	2,344	350	2,694
Constance Chandler	234,341.33	2,343	58.67	2,344	350	2,694
Norman Chandler	215,813.61	2,158	86.39	2,159	350	2,509
Harry Chandler				200	200	200
	<u>\$3,515,606.88</u>	<u>35,153</u>	<u>\$593.12</u>	<u>33,288</u>	<u>5,000</u>	<u>40,162</u>

(c) Notwithstanding the foregoing, the Respondent has treated the transaction whereby Petitioner acquired stock in the Chandis Securities Company for her notes and accrued interest thereon as a payment of the accrued interest and has erroneously and illegally included in Petitioner's net taxable income for the year 1929 on this account the sum of \$661,369.56, contrary to the provisions of the Revenue Act of 1928 and the Sixteenth Amendment to the Constitution of the United States of America.

(1) The 14,720 shares of stock of the Chandis Securities Company received by Petitioner during the year 1930 on account of her ownership in the notes executed by the said Chandis Securities Company did not have a fair market value at the date received in excess of \$736,000.00.

(2) Petitioner's cost basis in the notes equals the principal of the said notes and is \$810,687.06,

Wherefore, Petitioner prays that this Board may hear and redetermine the deficiency in accordance with the foregoing. Petitioner prays for such other and further relief as may be deemed meet and proper in the premises.

GEORGE M. THOMPSON

JOHN T. RILEY

MARSHALL D. HALL

Counsel for Petitioner,
505 Title Insurance Building,
Los Angeles, California.

A. CALDER MACKAY

Attorney for Petitioner,
1104 Pacific Mutual Bldg.,
Los Angeles, California.

State of California

County of Los Angeles—ss.

Marian Otis Chandler being duly sworn, says that she is the Petitioner above named; that she has read the foregoing First Amended Petition or had the same read to her and is familiar with the statements therein contained; and that the facts therein stated are true except such facts as are recited to be upon information and belief and those facts she believes to be true.

(Signed) MARIAN OTIS CHANDLER

Subscribed and sworn to before me this 28 day of August, 1933.

[Seal] (Signed) C. O. DENNING

Notary Public in and for the County of Los Angeles, State of California.

[Endorsed]: Filed Sept. 25, 1933.

[Title of Court and Cause.]

ANSWER TO AMENDED PETITION.

Comes now the Commissioner of Internal Revenue, by his attorney, E. Barrett Prettyman, General Counsel, Bureau of Internal Revenue and for answer to the amended petition filed by the above-named taxpayer admits and denies as follows, to-wit:

1, 2, 3. Admits the allegations contained in paragraphs 1, 2, and 3 of the amended petition.

4. Denies the allegations of error contained in paragraphs 4(a) to (e), inclusive, of the amended petition.

5(a). Admits the allegations contained in paragraph 5(a) of the amended petition.

5(b). Admits that petitioner owned certain notes executed by the Chandis Securities Company, a corporation, aggregating in principal the sum of \$810,687.06 and interest had accrued upon said notes to December 31, 1929, aggregating the sum of \$661,369.56, but denies the remaining allegations of paragraph 5(b) of the amended petition.

5(b)(1). Admits the allegations contained in paragraph 5(b)(1) of the amended petition.

5(b)(2). Admits the Chandis Securities Company was incorporated during the year 1916 with an authorized capital stock of \$500,000.00, divided into 500 shares of a par value of \$1,000.00 each, but denies the remaining allegations of paragraph 5(b)(2) of the amended petition.

5(b)(3). Admits the Chandis Securities Company secured the consent of the noteholders to a plan whereby the said company would increase its capital stock to five million dollars, divided into 50,000 shares of the par value of \$100.00 each and thereafter acquire from the said noteholders their notes and the accrued interest thereon by the issuance of one share of its stock of the par value of \$100.00 per share for each \$100.00 of note principal, and accrued interest. Denies all other allegations

contained in paragraph 5(b)(3) of the amended petition.

5(b)(4). Admits that the Chandis Securities Company increased its capital stock to five million dollars, divided into 50,000 shares of the par value of \$100.00 each and issued to the petitioner and the other noteholders, one share of its stock (par value \$100.00) for each \$100.00 of note principal and accrued interest. Denies all other allegations set forth in paragraph 5(b)(4) of the amended petition.

5(b)(5). Denies the allegations contained in paragraph 5(b)(5) of the amended petition.

6. Denies the allegations contained in paragraph 6 of the amended petition.

7. Denies the allegations contained in paragraph 7 of the amended petition.

7(c). Admits the respondent has treated the transaction whereby petitioner acquired stock in the Chandis Securities Company for her notes and accrued interest thereon as a payment of the accrued interest and included in petitioner's net taxable income for the year 1929 on this account the sum of \$661,369.56, but denies the remaining allegations set forth in paragraph 7(c) of the amended petition.

7(c)(1). Denies the allegations contained in paragraph 7(c)(1) of the amended petition.

7(c)(2). Denies the allegations contained in paragraph 7(c)(2) of the amended petition.

Denies generally and specifically each and every allegation set forth in the amended petition not

hereinbefore admitted, qualified or denied.

Wherefore, it is prayed that the appeal be denied.

E. BARRETT PRETTYMAN

General Counsel,

Bureau of Internal Revenue.

Of Counsel:

MASON B. LEMING,

Special Attorney,

Bureau of Internal Revenue.

In the United States Circuit Court of Appeals for
the Ninth Circuit.

[Title of Cause.]

STATEMENT OF EVIDENCE

The following is a statement of evidence in narrative form in the above-entitled cause. This cause came on for hearing before the Honorable Ernest H. Van Fossan, Member of the United States Board of Tax Appeals on October 5, 1933, at Los Angeles, California. A. Calder Mackay and George M. Thompson appeared for the petitioner and Mason B. Leming (E. Barrett Prettyman, General Counsel, Bureau of Internal Revenue) appeared for the respondent.

Before any testimony was taken there was offered and received, on behalf of both parties, an agreed stipulation of facts with the annexed exhibits referred to therein. Thereupon, counsel for

the petitioner and counsel for respondent, in open court, stipulated that the value of the stock of the Chandis Securities Company was \$60.00 per share at any time material to these proceedings.

HORACE E. DOWNING,

being called as a witness by and on behalf of the petitioner, after being duly sworn, testified on direct examination as follows:

I am now and was in 1929 and for some years prior to that time assistant secretary of the Chandis Securities Company. As assistant secretary I was in charge of the stock certificate books of the Chandis Securities Company showing just who owned the stock of that company.

The stock of the Chandis Securities Co., prior to 1929 was owned by Mr. Harry Chandler, Mrs. Marian Otis Chandler, Mrs. Franceska Chandler Kirkpatrick, Mrs. May Chandler Goodan, Mrs. Ruth Chandler Williamson, Mr. Norman Chandler, Mr. Harrison G. Chandler, Helen Chandler and Phillip Chandler. As of December 31, 1929, each of the stockholders owned the following number of shares:

Marian Otis Chandler	200 shares
Franceska Chandler Kirkpatrick	35 “
May Goodan	35 “
Ruth Williamson	35 “
Norman Chandler	35 “
Harrison Chandler	35 “
Phillip Chandler	35 “

(Testimony of Horace E. Downing.)

Helen Chandler	35	“
Harry Chandler	20	“
Constance Chandler	35	“

The same condition prevailed with reference to share holdings of the old stock prior to December, 1929.

Continuing the witness testified as follows:

Q. I see. Now, who handled the issuance of the—I will withdraw that.

It is stipulated here, Mr. Downing, that the Chandis Securities Company made application for permit to increase its capitalization to \$5,000,000, and that new shares of stock were issued. I will ask you if you handled, you as assistant secretary of that corporation, the issuance of the new stock?

A. I did.

Q. And as assistant secretary of that corporation did you also—well, I will withdraw that.

It is further stipulated that this stock was issued, the new stock was issued for notes and interest, as well as some of the old stock. I will ask you if you handled the details with respect to receiving the notes and seeing that they were cancelled?

A. I did.

Q. Do you know, Mr. Downing, just when the notes that have been stipulated here and which were held by Mrs. Chandler and the other petitioners were cancelled?

A. Yes. They were cancelled on January 2, 1930.

(Testimony of Horace E. Downing.)

Q. I hand you herewith a bunch of notes, or a number of notes which appear to be pretty well plastered with documentary stamps cancelled, and I will ask you if these are the notes that you refer to when you say they were cancelled on January 2, 1930?

(The documents in question were passed to Mr. Downing.)

A. Yes.

Q. I notice on these notes, Mr. Downing, either a stamp or typewritten diagonally across here some writing. I will ask you if you know how that got on there and to tell the court just what that is.

A. That was a cancellation of the notes and was written in my office preparatory for the signature of the note owners.

Q. You say this was written in your office preparatory to that?

A. It was.

Q. And it was written under your direction?

A. Yes.

Q. It is stipulated that there were a number of notes which were cancelled at that time, and I will ask you if all of the notes at that time were cancelled on January 2, 1930?

A. They were.

Q. I will ask you whether or not this same writing on the face of it, that you have here described, was contained on all the notes?

A. It was.

Q. At that time?

A. It was.

Q. I will ask you to examine these notes and tell

(Testimony of Horace E. Downing.)

whether or not the writing is on them all, the writing showing the cancellation? A. It is.

Q. I notice as part of that writing there are names. I have in my hand a note of Marian Otis Chandler. I will ask you if that is her signature that you see written on it.

(The document in question was passed to Mr. Downing)

A. It is.

Q. Did you see her sign it? A. Yes.

Q. On these other notes I see the signatures of the various petitioners. Do you identify those signatures as the signatures of the various petitioners and the people that you have heretofore referred to as the stockholders of the Chandis Securities Company? A. I do.

Mr. Mackay: If your Honor please, there are numerous notes here. I should like to offer them in evidence at this particular time. I do not know whether it would be necessary to offer them all or not. They are all the same, and I would think that perhaps one would be sufficient, since they have been identified as all being the same. If counsel will not agree, we can offer all those notes. It is merely for the purpose of showing these notes were cancelled on January 2, 1930.

The Member: You have photostatic copies of them?

Mr. Mackay: Yes, your Honor.

The Member: Of all of them?

(Testimony of Horace E. Downing.)

Mr. Mackay: Well, I think I have. I have photostat copies of most of them, anyhow.

Mr. Leming: We have entered into a stipulation of fact which sets out the consideration for the issuance of these notes and what has happened to them in the way of payment of interest, and accrual of interest, the fact that in the year 1929 the stockholders proposed to accept stock for their indebtedness, the directors approved that proposal, subject to the approval of the Corporation Commissioner of the State of California, and the Corporation Commissioner approved it, all of which transpired in the year 1929.

I should like to ask counsel now the purpose in offering these cancelled notes.

Mr. Mackay: If your Honor please, in my opening statement I said that there was an issue here that we were contending that even though it is not held to be a reorganization, tax free, that nevertheless it is our contention that these petitioners never received anything during the year 1929.

My only purpose in offering these is to show that the notes were cancelled on January 2, 1930.

The Member: You are relying on an inference being drawn from that that they did not receive payment until 1930?

Mr. Mackay: Yes, I am following that up, if your Honor please. That is right.

Mr. Leming: May I examine the witness with respect to the notes?

(Testimony of Horace E. Downing.)

Mr. Mackay: Now, of course, if your Honor please, I want to clear up the record here. We do not take the position here, or the taxpayers do not, that there was any offer. We have put in all these documents showing the minutes of the meeting of the Board of Directors, and the application to the Corporation Commissioner and the permit issued, but we are not admitting for one minute that there was any offer and acceptance happening in 1929.

The Member: You are just stating the facts and submitting to the Board the question?

Mr. Leming: Mr. Downing, have you checked these notes to see that they are, in the aggregate, the same amount as mentioned in the stipulation of facts in the record?

The Witness: No, I have not; I do not know.

Mr. Leming: Will counsel state whether or not these conform to the stipulation of fact in aggregate amount?

Mr. Mackay: I do not know, Mr. Leming.

The Member: You are not offering it in proof of the amount, are you?

Mr. Mackay: No, because that was eliminated. All I wanted here—there may be some more. If you want me to get them all, I will get them.

Mr. Leming: I should think they would all be essential.

Mr. Mackay: The only way I can do it is to take a recess and check up. They may all be here. I do not know.

(Testimony of Horace E. Downing.)

Could we take a recess while we check this up, if your Honor please?

It is just a question of checking up the amount.

The Member: Very well.

(At this point a recess was taken, after which proceedings were resumed as follows).

The Member: Proceed.

By Mr. Mackay:

Q. Mr. Downing, I have in my hand now the notes that you have identified as the notes of Mrs. Chandler and the other petitioners here, and during the recess have you checked these notes to determine whether or not these are all the notes that were cancelled and for which stock was issued?

A. I have.

Q. All of these notes are of the same general form, are they not? A. Yes.

Q. Identical, with the exception of name and amount? A. Yes.

Q. You have examined all the notes and you find they contain a cancellation dated January 2, 1930? A. They do.

Q. Is it your testimony that these notes were cancelled on the date they purport to be cancelled?

A. They were.

Q. And they were cancelled by you?

A. They were.

Mr. Mackay: If your Honor please, at this time we offer in evidence these notes, with the right to withdraw or substitute photostat copies thereof.

(Testimony of Horace E. Downing.)

Mr. Leming: I believe your Honor gave me permission to examine the witness before they are ruled upon as to their admissibility?

The Member: Do you feel that is essential in determining the competency of the exhibit? Can't you leave that until cross examination?

Mr. Leming: If your Honor please, this witness has, as a matter of fact insufficient knowledge to justify their admission in evidence at this time. I would like to inquire if any of these petitioners are present?

Mr. Mackay: No, there are no petitioners present.

Mr. Leming: None of them are present in the courtroom?

Mr. Mackay: No.

Mr. Leming: Are any of them present in Long Beach?

Mr. Mackay: I do not know about that.

Mr. Leming: Where do they reside, in Los Angeles?

Mr. Mackay: They reside in Los Angeles.

Mr. Leming: Are they all there at this time?

Mr. Mackay: I do not know about that.

Mr. Leming: It seems to me that there has not been sufficient identification here of the subject matter that is supposed to represent the cancellation or the identity of the signatures of these several persons.

Now, if they offer them on the theory that they have been properly identified and accounted for as

(Testimony of Horace E. Downing.)

to notations and signatures, then, of course, I would object.

Mr. Mackay: Pardon me. I think I had better cover this in more detail.

The Member: Proceed:

By Mr. Mackay:

Q. Now,—

By Mr. Leming:

Q. Mr. Downing, I will ask you to please take the notes here—or I can do this, as your Honor suggests, to expedite the matter; I can proceed on cross examination to develop the matters and move later to strike.

Mr. Mackay: I will bring this out; I did not go through them and identify the signatures of each individual; but I should like to do that in order to perfect my record.

The Member: Proceed as rapidly as convenient.

By Mr. Mackay:

Q. Mr. Downing, I show you three notes here which you have identified as the Chandis Securities Company's and they are all made out to Marian Otis Chandler.

I shall ask you to please examine each one of these three notes and state whether or not on the face of them, under the writing you have identified as the writing you put on there when they were cancelled, you know the signature thereon is the signature of Marian Otis Chandler?

(Testimony of Horace E. Downing.)

A. It is.

Q. You are familiar with her signature?

A. Very.

Q. And you know it? A. Yes, sir.

Q. I show you three other sets of notes, apparently made out to Franceska Chandler Kirkpatrick, and I will ask you to state to the court whether or not you knew her signature and know her signature, and whether or not her signature appears on those notes in the places noted there for cancellation?

(The documents in question were passed to Mr. Downing.)

A. I know her signature, and that is her signature.

Q. I will ask you to examine all these notes and to read to the court the names, the payee of the notes, and state whether or not——

The Member: It will not be necessary to go into this detail unless you think it is very essential. Examine all the notes, and identify each one as to the payee of the note and the signature purporting to be a cancellation, and then state, if you will, whether or not they all bear the signatures.

The Witness: These notes are all canceled by the persons to whom they are made payable and the cancellation is in their handwriting. It is their signatures.

The Member: You are thoroughly familiar with the signature of each?

(Testimony of Horace E. Downing.)

The Witness: I am.

The Member: The signatures were made in your presence?

The Witness: They were.

The Member: They were made on January 2, 1930?

The Witness: They were made in the early part of January 1930. They may not all have been made upon that date.

The Member: Proceed.

Mr. Mackay: Now, if your Honor please, I think that the signatures of each one of these individuals have been properly identified, and I think that the notes have been properly identified as the notes of the petitioners here.

The Member: They may be received in evidence. You may substitute photostatic copies. You need not mark each of the originals. You can mark all of the photostatic copies.

The Clerk: Shall I make them all Exhibit 1?

The Member: Mark them all Exhibit 1.

(The documents referred to were received in evidence and marked collectively, "Petitioner's Exhibit No. 1", and made a part of this record.)

By Mr. Mackay:

Q. Now, Mr. Downing, did you also issue the stock of the Chandis Securities Company, the new stock? A. I did.

Q. I mean you took care of the details of issuing that? A. Yes.

(Testimony of Horace E. Downing.)

Q. Have you a record which shows when the stock was issued, and to whom? A. I have.

Q. Have you that in your possession?

A. I have.

Q. It has been stipulated that certain shares of stock were issued to the petitioners here in consideration for notes and accrued interest.

I will ask you to please examine your record and state to whom the stock was issued, and what date the stock was issued?

The Member: Are those facts stipulated?

Mr. Mackay: Not when it was issued, your Honor.

The Member: Not when it was issued?

Mr. Mackay: But to whom it has been issued. It has been stipulated, of course, the stock was issued to those individuals, and all I want to bring out by this witness is when those stocks were issued.

The Witness: Certificate Number 29 was issued to Marian Otis Chandler on January 2, 1930.

Certificate Number 30 was issued to Franceska C. Kirkpatrick on January 2, 1930.

Certificate Number 31 was issued to May C. Goodan on January 2, 1930.

Certificate Number 32 was issued to Helen Chandler on January 2, 1930.

By Mr. Mackay:

Q. Just a moment. All right; go ahead.

A. Certificate Number 33 was issued to Phillip

(Testimony of Horace E. Downing.)

Chandler January 2, 1930.

Certificate Number 34 was issued to Ruth C. Williamson on January 2, 1930.

Certificate Number 35 was issued to Harrison G. Chandler on January 2, 1930.

Certificate Number 36 was issued to Constance Chandler on January 2, 1930.

Certificate Number 37 was issued to Norman Chandler on January 2, 1930.

Q. Now, Mr. Downing, you have in your possession the stock certificate stubs do you not?

A. Yes I have.

Q. For the stock that you have just read?

A. Yes.

Q. I will ask you if there is a signature on each one of those stock certificate stubs showing the issuance of the stock that you have just related?

The Member: Showing the issuance or the receipt?

Mr. Mackay: Showing the receipt. Thank you, your Honor.

The Witness: There is.

By Mr. Mackay:

Q. Do you identify those signatures as the signatures of the petitioners?

A. They are.

Q. And they are the same signatures that you have identified as being on the notes, the cancellation of notes?

A. They are.

(Testimony of Horace E. Downing.)

Q. Do those stock certificate stubs show what date the stock was issued to these individuals?

A. Yes, they do.

Q. What dates do they show?

A. January 2, 1930.

Q. In each instance?

A. In each instance.

Q. Now, you have had photostatic copies made of these certificates, and also the stubs, have you not, Mr. Downing?

A. I have.

Q. And you gave them to me?

A. I did.

Q. I hold in my hand the photostat copies of the certificates that you have just enumerated, which also contain, I believe a photostat copy of the stubs, and also the backs.

I will ask you to please examine these photostat copies and state—just a moment before I do that.

I will first ask you if from the stubs you have read here, stock certificate stubs, there have been detached the certificates Mr. Downing?

A. Yes.

Q. When you had these photostats made, were the certificates laid along opposite the certificates or the stubs?

A. It would appear so.

Q. Yes. I will ask you to please examine these photostats I show you now and state to the court whether or not those are photostat copies of the certificates and the stubs that you have just referred to?

(The documents in question were passed to Mr. Downing.)

(Testimony of Horace E. Downing.)

Mr. Mackay: That is quite evident, Mr. Leming. I could separate those with a knife, if you want me to, but I think for convenience they should all be there together.

The Witness: They are.

By Mr. Mackay:

Q. I notice on the back of each one, the back, what appears to be the back of the stock certificate; is that right, Mr. Downing? A. That is right.

Q. And at the right hand side there are some cancelled document stamps. Where did you get that picture from? Is that from the back of the stock certificate stubs?

A. That is the back of the stock certificate stubs.

Q. And when were those—when those were photostated, the certificates were not attached, were they? A. They were not.

Mr. Mackay: We would like to offer in evidence the stock certificates which were issued at that time, and also the stubs, and I should like to substitute photostat copies of the documents which I just referred to.

I call your Honor's attention to the fact they appear to be together, but they were not together when they were actually photostated. It is quite evident that they were placed together, as you can see from some of the marks.

The Member: Any objection?

Mr. Leming: Only on the ground of materiality, if your Honor, please.

(Testimony of Horace E. Downing.)

The Member: They may be received as Exhibit Number 2. They will be marked as indicated in the last exhibit preceding this.

(The documents referred to were received in evidence and marked collectively, "Petitioner's Exhibit No. 2", and made a part of this record.)

By Mr. Mackay:

Q. I think I have asked you, but to make sure, Mr. Downing, from your own personal knowledge do you know when these stock certificates that have just been received in evidence were issued by the corporation, issued by you? A. When?

Q. Yes. A. On January 2, 1930.

Q. January 2, 1930? A. Yes.

Q. Mr. Downing, it has been stipulated here that there were outstanding a certain number of notes on January 1, 1923, which contained a provision, of course, that interest should be paid. Do you know how that interest was handled on the books of the Chandis Securities Company?

A. The interest was charged as an expense of operation for the year and was credited to the account in the ledger which contained the principal of the note of the payee.

Q. Mr. Downing, have you a record here of the Chandis Securities Company, other than the stock certificates, showing just when these stocks were issued? Have you the stock journal, Mr. Downing?

A. No.

Q. Have you any journal here? A. No.

(Testimony of Horace E. Downing.)

Q. Did you prepare a statement, a balance sheet of the Chandis Securities Company, a closing balance sheet for the year 1929? A. Yes.

Q. There was one prepared under your direction? A. There was.

Q. From what books did you prepare the statement, Mr. Downing?

A. From the general financial books of the corporation, which were concentrated in what we call the balance sheet book.

Q. And you have that book in court?

A. That book is here.

Q. I show you a paper here and ask you if that is a summary showing the closing balance sheet of the Chandis Securities Company for the year 1929?

(The document in question was passed to Mr. Downing.)

A. It is.

Q. Now, Mr. Downing, you have already identified this as a statement that you prepared from the books, and I notice that there are notes payable here to the various individuals, including, of course, the petitioners here before the Board, and opposite each is the amount.

I will ask you if that amount represents just the principal of the notes or whether it includes the accrued interest also at that time?

A. That includes the accrued interest.

Q. I see. A. At that time.

(Testimony of Horace E. Downing.)

Mr. Mackay: If your Honor please, we offer the statement in evidence.

The Member: Any objection?

Mr. Leming: May I inquire the purpose of the offer?

Mr. Mackay: The only purpose for which we offer this in evidence is merely to show that the closing balance sheet of the Chandis Securities Company did disclose these notes payable.

Now, counsel in his opening statement there has stated the corporation did take as a deduction the interest that had accrued, and this is merely to show that the corporation at the end of the year in its closing balance sheet treated these notes as notes payable. It shows——

The Member: Is that shown to refute his suggestion?

Mr. Mackay: No.

The Member: That they had taken deductions of these amounts?

Mr. Mackay: I beg pardon?

The Member: I say is that shown to refute the suggestion of government counsel that they had taken deductions of these amounts?

Mr. Mackay: Not at all. It is offered to show that this transaction was not closed in 1929. We think it is a chain in the evidence.

The Member: Very well.

The Member: Very well.

(Testimony of Horace E. Downing.)

Mr. Leming: I object to the document because it is inconsistent with the stipulated facts.

The Member: Will you point to the inconsistency, Mr. Leming?

Mr. Leming: Because it has been stipulated that the stockholders offered and the directors accepted in proposal to give them stock for their indebtedness in the year 1929, subject only to the approval of the Corporation Commissioner; and the Corporation Commissioner's approval was given in the year 1929.

It is wholly immaterial whether a physical stock certificate was issued, for counsel has not stipulated—I do not recall that he has—these notes were not a liability of this corporation after 1929. They did not pay any interest on them after 1929. There did not accrue any after 1929.

Now, it seems to me to offer something to show that they had them at the close of business December 31, 1929, is certainly inconsistent with most of the stipulated facts.

Mr. Mackay: Your Honor, I do not see the inconsistency there. The stipulation——

Mr. Leming: As I understand it, he offers this to show that they still owed these people these sums at the close of business——

Mr. Mackay: In 1929.

Mr. Leming: —December 31, 1929.

The Member: I think it goes to the heart of

(Testimony of Horace E. Downing.)

his theory of proof on that angle of the case, and for that reason I will admit it.

The Clerk: Exhibit 3.

The Member: It will be received as Exhibit 3.

(The document referred to was received in evidence and marked "Petitioners' Exhibit No. 3", and made a part of the record.)

Mr. Mackay: Of course, the record is quite clear. I did not go into detail about the stipulation, if your Honor please.

The Member: That will be a matter for argument. Anything you have to say you can put in your brief, if you wish to argue this question of consistency or inconsistency.

Mr. Mackay: What I had in mind was this: Several statements have been made by counsel that we have agreed there was an offer and an acceptance. Perhaps from the document he may argue there was, but I will not admit it as a fact.

On Cross-Examination.

Mr. Downing testified as follows:

The stockholders of the Chandis Securities Company are members of one family. This has always been true of the stock ownership. I have been with the corporation since it was created in 1916. I have been with the Chandler family since 1902. The Chandis Co. was organized at the instigation of Mr. Harry Chandler who was the senior member of the Chandler family. He is the one with whom I have been since 1902.

(Testimony of Horace E. Downing.)

I have not always been the custodian of these notes. I can not state definitely when they came into my custody the last time. I know Revenue Agent Donally who is sitting here in court. I did not inform him in October, 1931, that these notes were cancelled in 1929. I don't remember whether I informed him at that time that they were in my possession in the year 1929. I will say that I do not remember that I so informed him. They were in my possession in the year 1929. I had them previous to the year 1929, but I can't tell how long previous to that year. I had all of these notes in my possession throughout the year 1929. I did not act as a secretary for all the members of the Chandler family, but they entrusted to my keeping these notes. The notes were kept in the safe which belongs to the Times Mirror Co., which is situated in my room. In the office of the Times Mirror Co., within which the business of the Chandis Securities Co., is transacted. I could not say whether I had the notes all during the year 1928. All of the other records of the Chandis Securities Co. are kept in that same safe, and were so kept throughout the year 1929. I can not say positively whether they were kept there throughout 1928. I can not tell you when I first begun to put things in the safe that belonged to the Chandis Securities Co. It was

(Testimony of Horace E. Downing.)

a progressive matter. I moved in that office in 1923. The safe was not there at that time. Before the safe was moved into the office I kept the records in a very unsatisfactory place, in some filing cabinets. I did not keep all of the records of the Chandis Securities Co. in that filing cabinet in 1923. I would not attempt to say how long I was there before I got a safe.

Continuing the witness testified as follows:

Q. Mr. Downing, did any one of these petitioners ever have their hands on these notes at all?

A. Why, most assuredly they did.

Q. When?

A. When they were executed.

Q. How long did they keep them in their possession at that time?

A. That I cannot tell you.

Q. Isn't it a matter of fact that they handed them right back to you?

A. That also is something I cannot tell you positively about, but I think not.

Q. I will ask you, Mr. Downing, if you did not tell Revenue Agent Donally in October, 1931, that exchange of stock for the indebtedness took place in the year 1929, and the notes were cancelled in the year 1929, and the physical issuance of the stock certificates simply was a mechanical action which was delayed because you did not have the certificates printed?

A. I have no recollection of that conversation with Mr. Donnally.

(Testimony of Horace E. Downing.)

Q. You have no recollection of telling him that the only reason the certificates were not issued in 1929 was because the printer had not printed them?

A. Why no.

Q. You did not tell him that?

A. I have no recollection of telling him that. The stock certificates, if I may say so, are the same certificates which we had previously. The books will show that.

Q. When did you have the certificates printed to take care of the issuance of the new stock?

A. They were not printed. They are the same certificates.

Q. Did they come out of the same stock certificate book?

A. Absolutely, yes, sir.

Q. Did you tell Mr. Donnally then that all that remained to do was the physical mechanical issuance of those certificates?

A. I have no such recollection.

Q. Assuming I am mistaken, Mr. Downing, as to how he said that, I want to be clear with you on this point: Didn't you tell him that nothing remained to be done in 1929 but the mechanical issuance of the stock certificates?

A. I have no recollection of telling him that.

Q. Well, if Mr. Donnally says that is what you did tell him, what would you say to that?

A. I probably should not say anything to it.

(Testimony of Horace E. Downing.)

the amended petitions were filed the first day your Honor sat out here.

The Clerk: The 25th.

Mr. MacKay: Which was the 25th of September. Prior to that time I did not feel I could file them, because other members of the Board were out here, and I understood their paraphernalia and records were going north.

Mr. Leming: You mean to say you spoke to me after I arrived in Los Angeles in August, recently?

Mr. MacKay: Yes. I think it was after you had arrived that I was retained, so I will take the blame for raising that issue.

Mr. Leming: May we see the original stock certificates that have been offered in evidence?

(The documents in question were passed to Mr. Leming.)

Mr. Leming: What I would like to have is the stock certificates issued here in that sum, authorized by the Corporation Commissioner, in the total sum we have stipulated? Didn't you offer those in evidence?

Mr. MacKay: Yes. I thought they were here. Mr. Downing, did you bring the original certificates that were issued on January 2, 1930? I understood you that you have them down here?

The Witness: Did I bring them?

Mr. MacKay: I understood you had them down here with you.

The Witness: They are available.

(Testimony of Horace E. Downing.)

Mr. MacKay: I am sorry.

Mr. Leming: Have these been offered in evidence?

Mr. MacKay: Yes, they were offered in evidence and photostats substituted.

When did you have a new certificate book printed, Mr. Downing?

The Witness: We had no new certificate book printed.

Mr. MacKay: And you had none up to this time?

The Witness: No, sir.

Mr. MacKay: Do you have the journal of the Chandis Securities Corporation here, Mr. Downing?

The Witness: No, sir.

Mr. MacKay: Doesn't that journal show the fact that those stock certificates were issued as of December, 1929?

The Witness: No, sir.

Mr. Leming: If your Honor please, I would like to have that journal produced.

The Witness: Well,—

Mr. MacKay: Have you a sheet showing that?

Mr. Leming: Let us see the journal book, the original entry in that book. If it is not here, I think it is of sufficient importance to ask his Honor for a subpoena for it.

Mr. MacKay: We will get it. There is no need to subpoena it. We will get anything that you want.

Mr. Leming: All right, thank you.

Mr. MacKay: I had intended to go into that matter. May I take the witness for a minute?

Mr. Leming: All right.

(Testimony of Horace E. Downing.)

By Mr. MacKay:

Q. Mr. Downing, I will hand you some papers and ask you if that is the original entry that was made by you or under your direction, showing the original entry made in any records of the Chandis Securities Company, showing when the stock certificates were issued? I am referring to the new certificates.

A. This is a rough draft of the journal entries from which the entry was made in the journal, the permanent journal of the Chandis Securities Company.

Q. I see. And have you made a copy of that or a summary of it?

A. I have, yes, sir.

Q. I show you a document and ask you if that is a summary that you have made of it, or is it a true copy, which?

(The document in question was passed to Mr. Downing.)

A. It is a true copy of the entries as made in the journal. In explanation of that, I may say for your information that here is some——

Q. You are turning to the second page there?

A. The second page. There is some collateral information here which is not pertinent to the original entries, and which was eliminated.

Q. What is this paper? You say it is the original entry. Where has it been kept?

A. It has been kept in the office of the Times Mirror, Chandis Securities Company, in Room 1.

(Testimony of Horace E. Downing.)

Q. That is, your journal up in Los Angeles?

A. Yes.

Q. It can be brought down here if necessary?

A. Yes.

Q. Do you know what date the journal itself shows the entries were made?

A. In April, 1930.

Mr. MacKay: If your Honor please, I am just offering this testimony to clear up an inference that was raised on cross examination, and I offer this in evidence and would like to substitute a copy of it.

The Member: Do you wish to examine this, Mr. Leming?

Mr. Leming: Yes, your Honor.

(The document in question was passed to Mr. Leming.)

Mr. MacKay: I may state for the record that I intended to go into that and the reason that was brought down I expected to prove that fact. Mr. George M. Thompson and I consulted on that before we began, and came to the conclusion it was not necessary to burden the record with any more detail along that line. It is merely cumulative, anyway of what we put in.

The Member: Proceed:

By Mr. Leming:

Q. Mr. Downing, did you take this data off the books yourself on these yellow sheets?

(Testimony of Horace E. Downing.)

A. No, sir. That is the data from which the books themselves were written.

Q. Now, just what do you mean by that?

A. That is a rough draft, preparatory draft of data to be transcribed into the financial journal.

Q. Who made this rough draft?

A. That was made by a bookkeeper by the name of Mr. Hess, and was submitted to me for approval.

Q. Are there identifying marks on it of yours in any way?

A. Yes. There are some interpolations. There is one, and this is my handwriting.

Q. When you say this is your handwriting, just read what you say is your handwriting?

A. "See Corporation Commissioner's permit Number L. A.-264 dated December 26, 1929."

Q. That appears right under what? Read what appears as the caption of that.

A. "Subscriptions to stock. To capital stock subscribed to record subscriptions to stock by the following people at \$100 per share."

It goes on and states these people, with the number of shares opposite their names.

Q. You say the thing you have in your hand and which has just been offered in evidence by counsel for the petitioners——

The Member: It has not been marked.

(Testimony of Horace E. Downing.)

By Mr. Leming:

Q. (Continuing) But not yet marked. You say that document, or those documents, which are pinned together, became the basis of the journal entries? A. They did.

Q. I do not know much about bookkeeping, but I assume from what you say that somebody first makes a notation of what is to go into a journal, and that goes to the bookkeeper and he records it; is that right?

A. Usually the other way. The bookkeeper usually makes the proposed journal entries and sends them to me, and I return them to him and he incorporates them into the financial books.

Q. Is he supposed to put it into the books just as you have approved it?

A. All with the exception of changes in error or context.

Q. Do you recall what the books actually show about this journal entry J-193-22?

A. Do I what?

Q. Do you recall offhand or can you refresh your recollection any way and say what the journal actually shows as to this entry described as J-193-22?

A. No, I cannot. Have you anything there that purports to be it?

Q. I have a notation here which purports to be it, and it says "Part payment by cancellation of

(Testimony of Horace E. Downing.)

note plus interest as of December 31, 1929." That purports to be a direct copy from the book itself. Would you say that would be right?

A. I should judge so, yes.

Q. Then right under it shows the amount of each one, for instance, M. O. Chandler, \$1,472,056.62, and the others in order, which are the same amounts as described in the stipulation of facts, if I am not mistaken.

A. Yes. This is right. This states just exactly what it is.

Q. All right. It also shows the stock they got and the cash they paid.

A. Not at that time, not as of December 31, 1929. That refers to interest only, plus interest as of December 31, 1929. That does not refer to the cancellation of the stock at that date, or the net. It refers to plus interest as of December 31, 1929.

Q. There was not any interest after that date, was there?

A. There was not.

Mr. Leming: Did you offer this?

Mr. MacKay: Yes.

Mr. Leming: No objection.

The Member: It will be received as Exhibit Number 4.

(The document referred to was received in evidence and marked "Petitioner's Exhibit No. 4" and made a part of this record.)

Continuing the witness testified:

(Testimony of Horace E. Downing.)

I have a very definite recollection that the long delay between the issuance of the stock certificates on January 2, 1930, and the entries made in the books in April or May, 1930, was due to the press of work occasioned by the United States Government income tax. No, that was not in progress also in December, 1929. We could not do anything regarding the income tax for the year 1929 until after the close of our fiscal year. It was immediately after the close of 1929 that we began to get our income tax returns ready for the year 1929. We commenced to correlate them in January.

Referring to Petitioner's Exhibit No. 1, and to the typewritten matter across the face of the notes, I did not do that typing.

Continuing the witness testified:

Q. You have had occasion no doubt to handle a good deal of negotiable paper, have you not?

A. Some.

Q. Well, if you had a note outstanding and you paid the note off and somebody had returned the note to you, would you consider the note cancelled?

A. Not unless they cancelled it themselves. I should require the cancellation of it.

Q. If the note had been paid and the note was delivered back to you—for instance, if you gave a note to somebody and that note was paid and the note returned to you, you would regard that note as cancelled, wouldn't you?

A. No, sir, I would not.

(Testimony of Horace E. Downing.)

Q. If you paid it and got the note back in your own possession you would still say you would not regard it is cancelled?

A. No, sir, I would not. I might lose that note, I would not.

Q. In other words you would think somebody would have to write across it and say, "It is hereby cancelled"? A. Yes, sir.

Q. In your own opinion there is no cancellation until somebody does that?

A. That is my opinion.

Mr. Leming: That is all.

Mr. MacKay: If your Honor please, I have just sent to Los Angeles for that journal record to clear up that matter. It may not be here until two o'clock. I understand counsel has no witnesses, and we perhaps could close before that, but I should like very much to clear that up and show just when those journal entries were made, because we want to overcome the inference I think has been wrongly drawn from it.

Mr. Leming: Your Honor, there is no controversy between us as to when the journal entry was made. That was made in 1930.

Mr. MacKay: All right.

Mr. Leming: But the journal shows it was made as of December, 1929.

Mr. MacKay: Whatever that shows then.

(Testimony of Horace E. Downing.)

Mr. Leming: There is a slight discrepancy between what he says was the pattern for the journal entry and the actual journal entry, but if it is agreed it was as of December, 1929, I have no objection.

Redirect Examination

By Mr. MacKay:

Q. Will you examine Exhibit Number 4 and state when that journal entry was made?

A. In April, 1930.

Q. Was it made as of any date?

A. As of April, 1930.

Q. Was it made as of December 31, 1929?

A. No.

Q. Mr. Downing, I neglected on my direct examination to have you identify the stock certificates that were issued, I believe, pursuant to the permit dated in May, which is stipulated and which were issued to the old stockholders in exchange for their stock. I show you a number of certificates, and I ask you to identify those and state what they are?

A. These are the certificates which were issued in lieu of the former certificates outstanding, representing the original capitalization.

Q. And were they issued on the date that they bear?

A. May 7, yes.

Q. May 7th, when?

A. 1930.

Q. Would you please turn to the stubs in the stock book which I hand you and turn to the stubs Numbers 38, 39, 40, 41, 42, 43, 44, 45, 46 and 47.

(Testimony of Horace E. Downing.)

A. Yes, sir.

Q. I will ask you to please state if on those stubs there are signatures of the petitioners that you have identified before? A. There are.

Q. And they show that the stock was received on May 7th, 1930?

A. They show the stock was issued on May 7, 1930.

Q. I see. And there were documentary stamps, were there, attached to those certificates?

A. No.

Q. It was a new issue? A. No.

Q. You at my request prepared or had photostats made, did you? A. Yes, I did.

Q. Of these stubs and certificates?

A. I did.

Q. At the time these photostats were made, were the certificates attached to the stubs?

A. No, they were not.

Mr. MacKay: If your Honor please, I should like to offer in evidence these original stubs that I have referred to here, and also the original certificates, with the privilege of withdrawing them and substituting photostat copies.

The Member: Any objection?

Mr. Leming: No.

The Member: They will be Exhibit Number 5.

(The documents referred to were received in evidence and marked "Petitioner's Exhibit Number 5", and made a part of this record.)

(Testimony of Horace E. Downing.)

Continuing the witness testified:

I also do work for the Times Mirror Co., and did in 1929. I have been doing work for the Times Mirror Co. for some time, so my duties are not confined just to the mere routine of the Chandis Securities Co. Confining myself to around 1929 and 1930, besides taking care of the issuance of stock of the Chandis Securities Co. and so forth, I am employed by the Times Mirror Company in the capacity of auditor and assistant secretary. That carries with it the necessity of doing the work which may arise in the Chandis Securities Co. Also it requires my attention to a great many of the individual requirements of the members of the executive committee of the Times Mirror Co., among whom are Mr. Harry Chandler and Mr. Pfaffinger. Mr. Harry Chandler and Mr. Pfaffinger are on the executive committee of the Times Mirror. Then in addition there is all the work which naturally gravitates to an office like that. It has to do with individual members of the Times Mirror organization. Some of those are R. W. Trueblood, S. W. Crabell, J. Baum, A. N. Damon, and many others. The Times Mirror Company is the organization that prints the Los Angeles Times newspaper.

Continuing the witness testified and the following colloquies occurred:

Q. I see. Now, you have been asked on direct examination—or on cross examination, rather, to a considerable extent about the safe that is in your office. I will ask you to please state to this Board

(Testimony of Horace E. Downing.)

just who uses that safe for keeping their valuables or records, or whatever they keep in it?

A. I am afraid that that would take——

Mr. Leming: If your Honor please, I object to this line of redirect examination. The only reason for the discussion of the safe was this: It was being inquired of this witness as to when he got these particular notes, and how long he had had them in his possession, and he said he had them in his possession throughout the year 1929, and he had them in that safe. There is no occasion for any redirect examination on that.

The Member: I think it is merely piling up the record.

Mr. MacKay: If your Honor please, the inference was drawn, at least that I got from his cross examination, that these notes were just given to him there. I want to bring out this fact, that these notes were in that safe, as were the stock certificates after, and that this safe was not only used for the Chandis Securities Company, but——

The Member: What difference does it make how many people used it?

Mr. MacKay: I know, but I want to make sure this Board does not get the idea these notes were not genuine notes and that they were held by this man other than as a mere safe-keeper for the individuals who put their notes in the safe, and where their stock has always rested. That is the reason I am bringing that out.

(Testimony of Horace E. Downing.)

The Member: I will sustain the objection to the question that was asked.

Mr. MacKay: Read the question, please, Mr. Reporter, so I may understand it at least.

(The pending question was read by the reporter as follows:

“Q. I see. Now, you have been asked on direct examination—or on cross examination, rather, to a considerable extent about the safe that is in your office. I will ask you to please state to this Board just who uses that safe for keeping their valuables or records, or whatever they keep in it.”)

Mr. McKay: Note an exception, please.

Q. Mr. Downing, there are stock certificates that have been offered in evidence? A. What is it?

Q. The stock certificates of the Chandis Securities Company, which have been offered in evidence here and which were issued on January 2, 1930, I will ask if those certificates were kept in the safe?

A. They were.

Q. In the same safe that you had theretofore kept the notes? A. They were.

Q. I see. And they were kept in that safe, were they, for safekeeping for the various individuals?

A. They were.

Q. And when I speak of the various individuals, I mean the various individuals to whom they belonged? A. They were.

Q. I will ask you if you were at any time the business manager of the various petitioners here,

(Testimony of Horace E. Downing.)

including Marian Otis Chandler, and the others?

A. I never was.

Q. You never were? A. No.

Q. Did you have any other duties with them, other than permitting them to keep in the safe the notes and the certificates and some other valuable papers?

A. That is all, with the exception of taking care perhaps of some of their income tax returns.

Q. I see. Did you have any other authority from these individuals than merely to provide a safe place for them to keep the notes and the certificates? A. Nothing.

On

Recross Examination

the witness testified as follows:

The stock of the Times Mirror Company is owned by 47 or 48 different people. The Chandis Securities Company now owns 1983 shares. I can not state without the stock records what percentage of the total number of shares it owned in 1929 or 1930. It is not a fact that the Chandis Securities Company owns most of the stock of the Times Mirror Company. It does not own a controlling interest in it. The Chandis Securities Company and the Chandler family, the nine petitioners here, own and control a majority of the stock of the Times Mirror Company. A majority of the stock of the Times Mirror Company is owned by the Chandis Securities Company and the Chandler family together.

(Testimony of Horace E. Downing.)

At this point it was agreed between counsel that a photostat copy of the journal page of Chandis Securities Company, showing the journal entry of April 26, 1930, would be later submitted in evidence in lieu of taking the time to obtain and produce the journal itself at the hearing. Whereupon the petitioners rested and the government rested at 12:45 o'clock p. m. October 5, 1933.

On motion of petitioners' counsel the hearing was reopened at 2:00 o'clock p. m. the same day and Horace E. Downing was recalled as a witness by and on behalf of the petitioners and on

Redirect Examination

testified as follows:

By Mr. Mackay:

Q. I show you the stock certificate book of the Chandis Securities Company which you have identified heretofore in this case, and I call your attention to Certificates 1 to 28, inclusive, which show a capital stock of \$500,000, having a par value of \$1000 per share.

The Member: And so printed on the certificate.

By Mr. Mackay:

Q. And it is so printed on the certificate. I will ask you to examine this book and state whether or not the certificates from 29 on contain the same capitalization or if there is a change?

A. There is a change, starting in with Certificate Number 29.

(Testimony of Horace E. Downing.)

Q. What is that change? Pardon me, go ahead.

A. Running through to certificate 103, and this change is composed of the addition of one cipher to the capital stock.

Q. Making it—— A. \$5,000,000.

Q. Instead of?

A. Instead of \$500,000 and no cents, and the addition of one cipher to the share each, with the interposition of a period, making it \$100 a share instead of \$1000.

Q. Mr. Downing, how do you account for the fact that the certificate in the same book are—that the certificates from 29 on are different than prior to 28?

A. That was occasioned by the application of economy, and it was occasioned, or, rather, it was arrived at, as I say, by the addition of ciphers and the putting in of *of* commas and periods.

Q. Do you call that an overprint?

A. That is what we call an overprint, yes.

Q. Do you know when that was done?

A. I cannot tell you definitely. It was just a part of the mechanics and I cannot tell you when it was done definitely.

Q. And this is the book you had in your hands previously when you testified it represented the books of the Chandis Securities Company?

A. Yes.

Q. From which you issued the shares in January, 1930, and also in May, 1930, the original stock

(Testimony of Horace E. Downing.)

of the Chandis Securities Company? A. Yes.

Mr. Mackay: That is all.

Cross Examination

By Mr. Leming:

Q. In other words, you had new certificates printed; is that right? A. No, sir.

Q. All right. What did you have printed? Let us use the word "print." I assume there was a print by a printing press, was there not?

A. There was not.

Q. How was it done? A. Pen and ink.

Q. Who did it with a pen and ink?

A. That was done by the job department of our institution.

Q. Let us see. Show me one in pen and ink.

A. That cipher is put in there in ink.

Q. That says \$500,000 capitalization, doesn't it?

A. No; it says \$5,000,000 capitalization.

Q. Which one was put in there by pen and ink?

A. The final cipher, right here (indicating).

Q. Who did that, you say?

A. It was done in our job department of the Times Mirror Company.

Q. You mean they have somebody in the printing office there who, instead of using type, takes a pen and ink, and does these things?

A. I do not know that they have anybody who does it that way, as a general rule, but it was done in this instance.

(Testimony of Horace E. Downing.)

Q. Did you do it? A. No, sir.

Q. Did you see it done? A. No, sir.

Q. You do not know when it was done?

A. No, I do not. I cannot tell you precisely.

Q. I want to ask you again if you did not tell Mr. Donnally that it was not done in 1929, and that is the reason there was a delay in the mechanics of issuing these certificates?

A. I have no recollection of that conversation with Mr. Donnally.

Q. Do you know whether this was done in 1929 or 1930? A. I do not.

Q. You would not undertake to say whether it was done in 1929 or 1930. A. I would not.

Q. But it had to be done before you issued the certificates; is that right? A. Yes, sir.

Q. When you say this was done in the job department of the Times Mirror Company, you have reference to the news company, that is the corporation which publishes the Times? A. I have.

The foregoing evidence is all of the material evidence adduced at the hearing before the Board of Tax Appeals, and the same is approved by the undersigned, Herman Oliphant, General Counsel for the Department of the Treasury, as attorney for the Commissioner of Internal Revenue.

(Signed) HERMAN OLIPHANT

General Counsel for the Department of the Treasury.

The foregoing evidence is all of the material evidence adduced at the hearing before the Board of Tax Appeals, and the same is approved by the undersigned, as attorney for the respondent on review.

.....

Th foregoing is all of the material evidence adduced at the hearing and is duly approved and settled this.....day of....., 1936.

.....

Member, United States Board
of Tax Appeals.

Approved and ordered filed this 16th day of April, 1936.

(Sgd) ERNEST H. VAN FOSSAN,
Member.

[Endorsed]: Filed Apr. 16, 1936.

128

50

35

10

10

10

10

10

①

\$2243.44
 On or before June 15, 1927
 Securities Co. promises to pay to Maximilian Otto Gumbel or order at

San Angeles, Cal.
 the sum of Nine hundred twenty four thousand three hundred and forty four and 5/100 Dollars

with interest at the rate of five percent per annum from
 date until paid, interest payable monthly and if not so paid
 to be compounded yearly, and bear the same
 rate of interest as the principal, and should ~~the~~ interest not be paid to ~~the~~
 then the whole sum of principal and interest shall become immediately due and
 payable at the option of the holder of this note. Principal and interest payable in
 gold coin of the United States.

Return 41

CHADWICK, S. & CO. COMPANY
 111 Broadway, New York
 By Maximilian Otto Gumbel 3007.

123

\$4437.34

San Angeles, Cal Dec 31 1923

On or before June (5) next after date for value received Camille's Securities Company
 Sum of \$4437.34 payable to Messrs. Otis Chandler & Co order at
San Angeles, Cal
 the sum of Four thousand four hundred and thirty seven and 34/100 Dollars
 with interest at the rate of five per cent per annum from
 date until paid, interest payable semi-annually and if not so paid
 to be compounded yearly, and for the same
 rate of interest as the principal; and should the interest not be paid
 then the whole sum of principal and interest shall become immediately due and
 payable at the option of the holder; this note Principal and interest payable in
 gold coin of the United States.

THIS IS A
 SECOND OF PRINCIPAL

Camille's Securities Company
 Otis Chandler & Co
 17 Maiden Lane, New York

Endorsements.

Principal Interest
13,596.05

Oct. 13, 1924

Above endorsement due to reduction of the Harry Chandler note because of erroneous credit of \$150,- 211.60 to the Harry Chandler account, the above sum of \$13,596.05 being this note's proportion thereof. See Journal 7-2 to 7-12 inclusive.

\$ 150,495.34

On or before four years

Company promise to pay to

Los Angeles, California

the sum of ONE HUNDRED FIFTY THOUSAND FOUR HUNDRED FIFTY-FIVE \$1100 Dollars

with interest at the rate of 4% per annum from date, until paid, interest payable

be compounded

rate of interest as the principal and should the interest not be paid

then the whole sum of principal and interest shall become immediately due and payable at the option of the holder of this note. Principal and interest payable in gold coin of the United States.

LOS ANGELES, CALIF. PRINCIPAL

January 31, 1924

after date, for value received CHANDLER SECURITIES

MEDIAN CO'S CHANDLER

or order at

1% per cent per annum

and if not so paid to

by 1% and if not so paid to

and bear the same

CHANDLER SECURITIES COMPANY

ATTEST

My hand

Attest

Notary Public

[Here follows matter consisting of notes identical with those appearing at pages 222 through 224, *mutatis mutandis*, issued by Chandis Securities Company to the other members of the Chandler family, omitted to avoid unnecessary duplication.]

FOLDOUT BLANK

168

Certificate

29

-14,721- Shares

Issued to

Marian Otis Chandler

date Jan. 11, 1930

Transferred from

And from

Original	Subsequent	Ac of Shares
Transferred	Shares	Transferred

THIS CERTIFICATE NO. 29

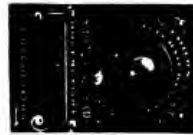
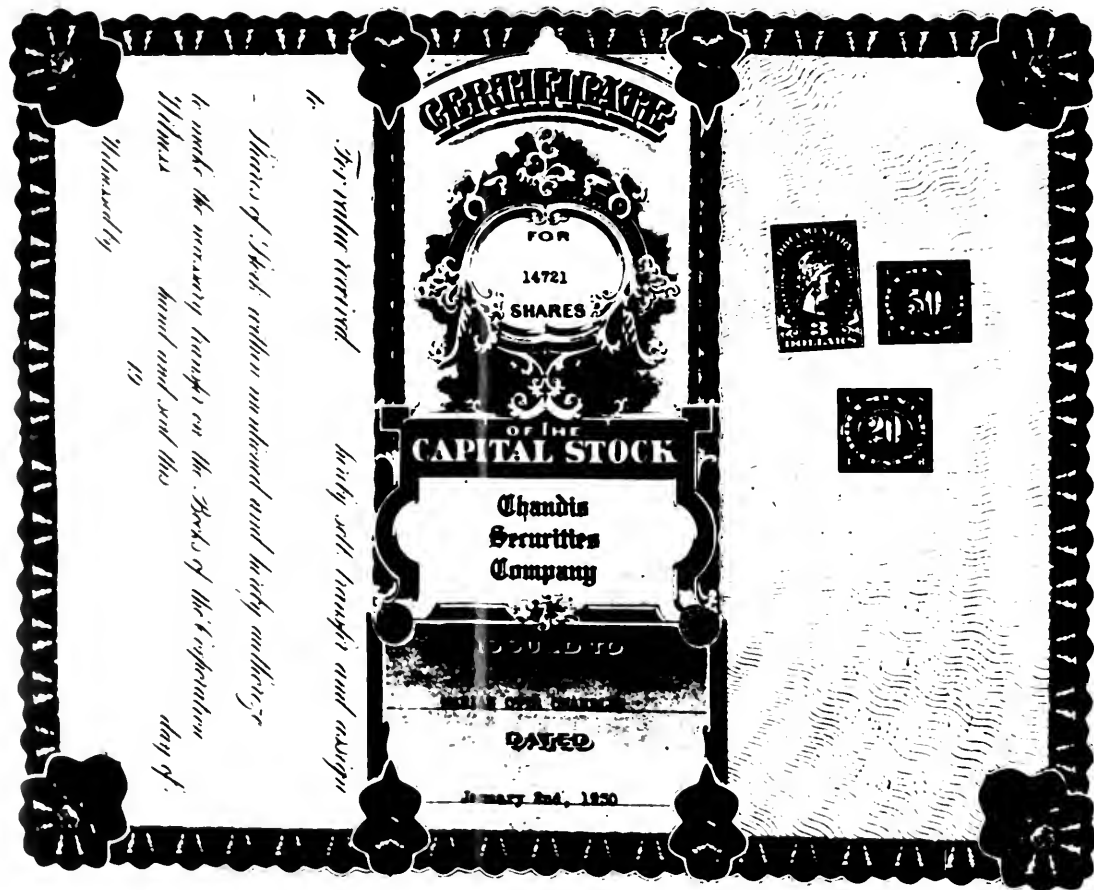
14,721 Shares

2nd day of May, 1930

By the Board of Directors



169



[Here follow stock certificates identical with those appearing at pages 226 to 227, *mutatis mutandis*, issued by Chandis Securities Company to the other members of the Chandler family, here omitted to avoid unnecessary duplication.]

CHANDIS SECURITIES COMPANY

BALANCE SHEET

December 31, 1929

Assets

Real Estate Loans.....	\$ 258,048.88
Other Loans	1,361,172.75
Bonds	50,616.00
Stocks	3,255,851.06
Sundry Assets	429,207.61
Real Estate	1,051,659.55
	<hr/>
	<u>\$6,406,555.85</u>

Liabilities

1001 Capital Stock	\$ 500,000.00
1002 Surplus	1,747,885.67
1004 Note Payable—Marian Otis Chandler.....	1,238,736.96
1006 Note Uayable—F. C. Kirkpatrick.....	287,145.33
1007 Note Payable—May C. Goodan.....	287,145.33
1008 Note Payable—FXP. Tr. H. Chandler.....	193,471.58
1009 Note Payable—FXP. Tr. P. Chandler.....	193,471.58
1010 Note Payable—Ruth C. Williamson.....	193,471.59
1011 Note Payable—H. G. Chandler.....	193,471.58
1012 Note Payable—Constance Chandler	193,471.60
1013 Note Payable—Norman Chandler	174,943.89
1014 Note Payable—Marian O. Chandler.....	41,245.25
1015 Note Payable—Constance Chandler	7,261.31
1016 Note Payable—F. C. Kirkpatrick.....	7,261.31
1017 Note Payable—H. G. Chandler.....	7,261.30
1018 Note Payable—FXP. Tr. H. Chandler.....	7,261.30
1019 Note Payable—FXP. Tr. P. Chandler.....	7,261.30
1020 Note Payable—Norman Chandler	7,261.30
1021 Note Payable—Ruth C. Williamson.....	7,261.30
1022 Note Payable—May C. Goodan.....	7,261.30
1025 Note Payable—Marian O. Chandler.....	192,074.41

CHANDIS SECURITIES COMPANY

BALANCE SHEET—Cont'd

December 31, 1929

Liabilities—Cont'd

1026	Note Payable—Constance Chandler	33,608.42
1027	Note Payable—F. C. Kirkpatrick.....	33,608.42
1028	Note Payable—May C. Goodan.....	33,608.42
1029	Note Payable—Ruth C. Williamson.....	33,608.42
1030	Note Payable—H. G. Chandler.....	33,608.42
1031	Note Payable—FXP. Tr. P. Chandler.....	33,608.42
1032	Note Payable—FXP. Tr. H. Chandler.....	33,608.42
1033	Note Payable—Norman Chandler	33,608.42
1040	Trust #A-3872	93,735.18
1042	Unaccrued Profit	20,429.66
1043	Advance Rent Collections.....	3,758.33
1045	Harry Chandler—Personal	54.23
1046	The Times-Mirror Company.....	348.03
1048	Reserve—Depr. Hillhurst House.....	29,802.37
1049	Reserve—Depr. Hillhurst Furniture.....	21,229.13
1050	Reserve—Depr. Building, Calipatria.....	5,568.75
1051	Reserve—Depr. 933 South Olive Street....	3,877.65
1052	Reserve—Depr. 926 South Olive Street....	4,050.00
1060	Trust #5005—Deferred Credit.....	172,640.00
1061	Trust #4886—Deferred Credit.....	21,500.00
1065	Trust #3453—Deferred Credit.....	5,000.00
1068	Trust #S-5638	74,840.29
1071	F. X. Pfaffinger.....	325.00
1038	Chanslor-Canfield Midway Oil Co.....	372.08
1077	Southern Pacific Company.....	17,497.44
1084	Reserve for Depreciation A. S. Carr.....	11,250.00
1090	Wilshire & Westmoreland—Mtg. Payable	100,000.00
1092	Reserve for Depreciation—Cadillac Brougham	735.00
1097	Trust Deed Payable E½ Lot 3, Block A	36,697.23
1098	Reserve for Depreciation 1145 S. Hope....	3,705.37
1099	Log Cabin Mining Venture.....	15,300.00
1100	S. H. Woodruff.....	267.63
1101	Reserve for Depreciation 127 N. Irving Blvd.	188.39

\$6,406,555.85

[Endorsed]: Filed Oct. 5, 1933.

Chas. S. Smith Co. ✓

Journal Entry to Record Surrender in Capital
Stock from 500 shares of 1000 Par Value to 50,000 shares of
1000 Par Value

Apr 26-30

① Capital Stock Surrendered
Capital Stock

The record is in Capital Stock from
500 shares of 1000 Par Value to 50,000 shares
of 100 Par Value. See authorization of
Board of Directors, Page 110 of Minutes Book

② Surrender to State
Capital Stock Surrendered

The record is in Capital Stock from
500 shares of 1000 Par Value to 50,000 shares
of 100 Par Value. See authorization of
Board of Directors, Page 110 of Minutes Book

③ No. 10 Payable

Wm. C. Chandler
R. C. Chandler
Harrison B. Chandler
Constance Chandler

Wm. C. Chandler
R. C. Chandler
Harrison B. Chandler
Constance Chandler

Wm. C. Chandler
R. C. Chandler
Harrison B. Chandler
Constance Chandler

Wm. C. Chandler
R. C. Chandler
Harrison B. Chandler
Constance Chandler

Wm. C. Chandler
R. C. Chandler
Harrison B. Chandler
Constance Chandler

Wm. C. Chandler
R. C. Chandler
Harrison B. Chandler
Constance Chandler

Wm. C. Chandler
R. C. Chandler
Harrison B. Chandler
Constance Chandler

Wm. C. Chandler
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Constance Chandler

Wm. C. Chandler
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Wm. C. Chandler
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Wm. C. Chandler
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Constance Chandler

Wm. C. Chandler
R. C. Chandler
Harrison B. Chandler
Constance Chandler

Wm. C. Chandler
R. C. Chandler
Harrison B. Chandler
Constance Chandler

Wm. C. Chandler
R. C. Chandler
Harrison B. Chandler
Constance Chandler

450,000.00

3516700.00

67468

U.S. DEPT. OF TAXATION
DIVISION OF TAX EXEMPTIONS
JUL 5 1933
EXHIBIT 4

3516700.86

3516700.86

Wm. C. Chandler
R. C. Chandler
Harrison B. Chandler
Constance Chandler

Wm. C. Chandler
R. C. Chandler
Harrison B. Chandler
Constance Chandler

Wm. C. Chandler
R. C. Chandler
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Wm. C. Chandler
R. C. Chandler
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Wm. C. Chandler
R. C. Chandler
Harrison B. Chandler
Constance Chandler

Wm. C. Chandler
R. C. Chandler
Harrison B. Chandler
Constance Chandler

Wm. C. Chandler
R. C. Chandler
Harrison B. Chandler
Constance Chandler

Wm. C. Chandler
R. C. Chandler
Harrison B. Chandler
Constance Chandler

④

1931

1932

Rep'd. Clumpington to stock

to receive interest from 300 shares and to receive

in amount to representing the difference between

the 300 shares and the 100 shares of the same stock

of the net owing to the corporation

Thomas W. Chandler

W. C. King Patrick

May C. Chandler

John C. Chandler

Philip

Paul C. Chandler

William C. Chandler

Thomas

Thomas

Thomas

Thomas

Thomas

Thomas

4338

8496

8495

8494

8493

8492

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8490

8489

8488

⑤

Capital Stock, Subscribed

Capital Stock, Issued

In accordance with the following

certificates to the subscribers, a

Capital Stock

- Name -

Marion W. Chandler

W. C. King Patrick

May C. Chandler

John C. Chandler

Philip

Paul C. Chandler

William C. Chandler

Old Stock
Exchanged

None

350

350

350

350

350

350

350

350

350

350

350

350

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350

350

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350

350

New
Subscriptions

127-1

3281

3281

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2322

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U.S. DEPT. OF TAX AFFAIRS
DIVISION OF TAX EXCISES
DOCKET NO. 100-168
OCT 5 - 1933
PETITIONER'S EXHIBIT
REMARKS

4

OCT 5 - 1933

PETITIONER'S EXHIBIT

REMARKS

100-168

100-168

[illegible]



8-5



DATE		ACTIVITY BY	PERIOD	DISTRIBUTION OF INCOME				ACTIVITY BY	DISTRIBUTION OF EXPENSE				ACTIVITY BY	DISTRIBUTION OF ASSET PRINCIPAL								ACTIVITY BY	PERIOD	DATE	CREDIT	APR - 1920																																																																																																																																																																																																																																																																																																																																																																																																																																																																																																																																																																																																																																																																																																																																																																																																																																																																																																																																																																																																																																																																																																																																																																																																																																																																																																													
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Certificate

No. 38

— 7000 — Shares
Issued to
Wm. C. Chandler

May 7, 1930
Transferred from
owner of "S"

Nov. 23, 1916
Amount of Shares
Transferred
8 200 2000

CERTIFICATE NO. 38
2,000 Shares

28th day of May 1930

Wm. C. Chandler



THIS CERTIFICATE IS THAT
owner of TWO THOUSAND

MARIAN OTIS CHANDLER

"Petitioner's 5" is the
Shares of the Capital Stock of
Chaudis Securities Company

transferable only on the Books of the Corporation in person
or by Attorney or surrender of this Certificate.

The Officers and Directors of this Corporation have hereunto
subscribed their names and caused the separate Seal to be hereunto
affixed this 7th day of May 1930

Wm. C. Chandler

Wm. C. Chandler

[Here follow stock certificates identical with those appearing at pages 237 and 238, *mutatis mutandis*, issued by Chandis Securities Company to the other members of the Chandler family, here omitted to avoid unnecessary duplication.]

CORPORATION INCOME TAX RETURN

For Calendar Year 1929

File This Return with the Collector of Internal Revenue for Your District on or Before March 15, 1930

PRINT PLAINLY CORPORATION'S NAME AND BUSINESS ADDRESS

Chandler Securities Company
(Name)

100 No. Broadway

Los Angeles, California.

(Street and number)

(Post office and State)

Date of Incorporation

November, 1914.

Under the Laws of what State or Country

California

Kind of Business **Buying, Selling Holding & Leasing Real Estate & Personal Property.**

Is This a Consolidated Return of Two or More Corporations? **No**

GROSS INCOME

1. Gross Sales from Trading or Manufacturing Less Returns and Allowances

2. Less Cost of Goods Sold

(a) Inventory at beginning of year

(b) Merchandise bought for sale

(c) Cost of manufacturing or producing goods From Schedule A

(d) Total of lines (a), (b), and (c)

(e) Less inventory at end of year

3. Gross Profit from Trading or Manufacturing Item 1 minus Item 2

4. Gross Profit from Operations Other Than Trading or Manufacturing (State nature of business)

(a)

(b)

(c)

5. Interest on Bank Deposits, Notes, Mortgages, and Corporation Bonds

6. Rents

7. Royalties

8. Profit from Sale of Real Estate, Stocks, Bonds, and Other Capital Assets (From Schedule I)

9. Dividends on Stock of Domestic Corporations

10. Other Income (including dividends received on stock in foreign corporations) (State nature of business)

(a) Other Income

(b)

(c)

11. TOTAL INCOME IN ITEMS 3 TO 10

DEDUCTIONS

12. Compensation of Officers (From Schedule C)

13. Rent on Business Property

14. Repairs (From Schedule D)

15. Interest

16. Taxes (From Schedule E)

17. Losses (From Schedule F)

18. Bad Debts (From Schedule G)

19. Dividends (From Schedule H)

20. Depreciation (resulting from exhaustion, wear and tear, or obsolescence) (From Schedule I)

21. Depletion of Mines, Oil and Gas Wells, Timber, etc. (Schedule H, sub-section 1)

22. Other Deductions Not Reported Above. (Explain below, or on separate sheet)

(a) Salaries and wages (Not included in Item 12, or 14, or 15)

(b) Net Loss for prior year (Schedule I, sub-section 1)

(c) Sundry Expense on Real Estate

(d) Special assessments—Lighting, Etc.

(e) General Operating Expense

(f) Other Losses

23. TOTAL DEDUCTIONS IN ITEMS 12 TO 22

24. NET INCOME (Item 11 minus Item 23)

25. Less Credit of \$1,000 for each domestic corporation having a net income of less than \$25,000

Balance (Item 24 minus Item 25)

Income Tax Paid at Source (This credit can only be allowed to a non-resident foreign corporation)

Income Tax Paid to a Foreign Country or U. S. possession by a domestic corporation (see Inst. 27)

Income Tax (Item 24 minus Items 26 and 27)

This return must be marked "Amended" at top of return

Checks and drafts will be accepted only if payable to pay

No. 138
853290

RECEIVED

MAR 15 1930

Cash, Check, M.O., Cert. of Ind.

U. S. INT. REV. 8th CAL.

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Items	BEGINNING OF TAXABLE YEAR		END OF TAXABLE YEAR	
	Amount	Total	Amount	Total
ASSETS				
1. Cash		\$ 206,822.34		\$ 220,130.38
2. Notes receivable				
3. Accounts receivable	\$ 55,451.79		\$ 49,360.98	
Less reserve for bad debts		55,451.79		49,360.98
4. Inventories:				
Raw materials	\$		\$	
Work in process				
Finished goods				
Supplies				
5. Investments (nontaxable):				
Obligations of a State, Territory, or any political subdivision thereof, or the District of Columbia	\$		\$	
Securities issued under the Federal Farm Loan Act, or under such Act as amended				
Obligations of the United States or its possessions				
6. Other investments:				
Stocks of domestic corporations	\$3,118,640.89		\$3,555,851.06	
Bonds of domestic corporations	62,929.97		50,616.—	
Stocks and bonds of foreign corporations				
All other investments or loans	1,561,513.89	4,743,084.75	1,619,221.63	4,925,688.69
7. Deferred charges:				
Prepaid insurance	\$		\$	
Prepaid taxes				
All other				
8. Capital assets:				
Land		794,742.01	\$ 131,661.51	919,998.04
Buildings	\$ 127,583.78			
Machinery and equipment			21,229.13	
Furniture and fixtures	21,229.13			
Delivery equipment			1,800.—	
Automobiles	1,800.—			
Less reserves for depreciation	\$ 150,612.91		\$ 154,690.64	
	67,797.47	82,815.44	80,406.66	74,283.98
9. Patents				
10. Good will				
11. Other assets (describe fully):				
Miscellaneous	\$ 175,466.43		\$ 143,818.54	
12. Total Assets		175,466.43		143,818.54
		\$6,058,382.76		\$6,333,280.61
LIABILITIES				
13. Notes payable (less than one year)		\$ 23,643.21	\$	41,187.37
14. Accounts payable				
15. Bonds and notes (not secured by mortgage)		3,385,697.03		3,515,606.88
16. Mortgages (including bonds and notes so secured)		100,000.—		136,697.23
17. Accrued expenses:				
Interest	\$		\$	
Taxes				
All other deferred credits	377,017.49	377,017.49	298,168.28	298,168.28
18. Other liabilities (describe fully):				
Trusts		93,735.18	93,735.18	93,735.18
19. Capital stock:				
Preferred stock (less stock in treasury)	\$		\$	
Common stock (less stock in treasury)	500,000.—	500,000.—	500,000.—	500,000.—
20. Surplus	\$1,666,517.22		\$1,686,805.91	
21. Undivided profits	88,257.37	1,578,289.85	61,079.76	1,747,885.67
22. Total Liabilities		\$6,058,382.76		\$6,333,280.61
Remarks				

Page 3 of Return

SCHEDULE L—RECONCILIATION OF NET INCOME AND
ANALYSIS OF CHANGES IN SURPLUS

1. Net Income from Item 24, page 1 of the return.....	\$ 103,980.32
2. Nontaxable Income:	
(a) Interest on obligations of a State, Territory, or any political subdivision thereof, or the District of Columbia .....	.....
(b) Interest on securities issued under the Federal Farm Loan Act, or under such Act as amended .....	.....
(c) Interest on obligations of the United States or its possessions .....	.....
(d) Dividends deductible under Section 23(p) of the Revenue Act of 1928.....	136,786.43
(e) Proceeds of life insurance policies paid upon the death of the insured.....	.....
(f) Other items of nontaxable income (to be detailed):	
(1) Belridge Oil Co.—Difference between Cash Receipts and actual earnings.....	30,283.47
(2) .....	.....
(3) .....	.....
3. Charges against reserve for bad debts, if Item 18, page 1 of return, is not an addition to a reserve.....	.....
4. Charges against reserves for contingencies, etc. (to be detailed):	
(a) .....	.....
(b) .....	.....
(c) .....	.....
5. Total of Lines 1 to 4, inclusive.....	\$ 63,089.58
6. Total from Line 14.....	2,009.82
7. Net profit for year, as shown by books, before any adjustments are made therein (Line 5 minus Line 6).....	\$ 61,079.76
8. Surplus and undivided profits as shown by balance sheet at close of preceding taxable year.....	1,578,289.85
9. Other credits to surplus (to be detailed):	
(a) Moses K. Chandler Property.....	4,200.—
(b) Tract 1000	23,067.76
(c) Deferred Credit	84,768.54

10. Total of Lines 7 to 9, inclusive.....	\$1,751,405.91
11. Total from Line 17.....	3,520.24
<hr/>	
12. Surplus and undivided profits as shown by balance sheet at close of taxable year (Line 10 minus Line 11)	\$1,747,885.67
13. Unallowable deductions:	
(a) Donations, gratuities, and contributions.....	\$ 740.—
(b) Income and profits taxes paid to the United States, and so much of such taxes paid to its possessions or foreign countries as are claimed as a credit in Item 32, page 1 of the return.....	.....
(c) Federal taxes paid on tax-free government bonds .....	.....
(d) Special improvement taxes tending to increase the value of the property assessed.....	.....
(e) Furniture and fixtures, additions, or betterments treated as expenses on the books.....	.....
(f) Replacements and renewals.....	.....
(g) Insurance premiums paid on the life of any officer or employee where the corporation is directly or indirectly a beneficiary.....	.....
(h) Interest on indebtedness incurred or continued to purchase or carry obligations or securities the interest upon which is wholly exempt from taxation .....	.....
(i) Additions to reserve for bad debts which are not included in Item 18, page 1 of return.....	.....
(j) Additions to reserves for contingencies, etc. (to be detailed):	
(1) .....	.....
(2) .....	.....
(3) .....	.....
(k) Other unallowable deductions (to be detailed):	
(1) Income Tax	1,269.82
(2) .....	.....
(3) .....	.....
<hr/>	
14. Total of Line 13.....	\$ 2,009.82
<hr/>	
15. Dividends paid during the taxable year (state whether paid in cash, stock of the corporation, or other property):	
(a) Date paid..... Character.....	\$
(b) Date paid..... Character.....	.....
(c) Date paid..... Character.....	.....
(d) Date paid..... Character.....	.....

16. Other debits to surplus (to be detailed):	
(a) Prior Year Depr. 1145 S. Hope St.....	3,520.24
(b) .....	.....
(c) .....	.....
17. Total of lines 15 and 16.....	\$ 3,520.24

QUESTIONS

Kind of Business

1. By means of the key letters given below, identify the corporation's main income-producing activity with one of the general classes, and follow this by a special description of the business sufficient to give the information called for under each general class.

A.—Agriculture and related industries, including fishing, logging, ice harvesting, etc., and also the leasing of such property. State the product or products. B.—Mining and quarrying, including gas and oil wells, and also the leasing of such property. State the product or products. C.—Manufacturing. State the product and also the material if not implied by the name of the product. D.—Construction—excavations, buildings, bridges, railroads, ships, etc., also equipping and installing same with systems, devices, or machinery, without their manufacture. State nature of structures built, materials used, or kind of installations. E1.—Transportation—rail, water, local, etc. State the kind and special product transported, if any. E2.—Public utilities—gas (natural, coal, or water); electric light or

power (hydro or steam generated); heating (steam or hot water); telephone; waterworks or power. E3.—Storage—without trading or profit from sales—(elevators, warehouses, stockyards, etc.). State product stored. E4.—Leasing transportation or utilities. State kind of property. F.—Trading in goods bought and not produced by the trading concern. State manner of trade, whether wholesale, retail, or commission, and product handled. Sales with storage with profit primarily from sales. G.—Service—domestic, including hotels, restaurants, etc.; amusements; other professional, personal, or technical service. State the service. H.—Finance, including banking, real estate, insurance. I.—Concerns not falling in above classes (a) because of combining several of them with no predominant business, or (b) for other reasons.

2. Concerns whose business involves activity falling in two or more of the above general classes, where the same product is concerned, should report business as identified with but one of the above general classes; for example, concerns in A or B which also transport and market their own product exclusively or mainly, should still be identified with classes A or B; concerns in C (manufacturing) which own or control their source of material supply in A or B and which also transport, sell, or install their own product exclusively or mainly, should be identified with manufacturing; concerns in D may control or own the source of supply of mater-

ials used exclusively or mainly in their constructive work; concerns in E1 or E2 may own or control the source of their material or power; concerns in F may transport or store their own merchandise, but its production would identify them with A, B, or C.

3. Answers:

(a) General class (use key letter designation)—
H.

(b) Main income-producing business (give specifically the information called for under each key letter, also whether acting as principal, or as agent on commission; state if inactive or in liquidation)—
Real Estate.

Affiliations with Other Corporations

See Instruction 38

4. Is this a consolidated return of two or more corporations?—No

[Balance of paragraph illegible.]

Predecessor Business

6. Did the corporation file a return under the same name for the preceding taxable year?—Yes. Was the corporation [illegible] result, continuation, or reorganization of a business or businesses in existence during this or any prior year since December 31, 1917?—No. If answer is “yes,” give name and address of each predecessor business, and the date of the change in entity.

Upon such change were any asset values increased or decreased?— — If the answer is “yes,” closing balance sheets of old business and opening balance sheets of new business must be furnished.

Basis of Return

7. Is this return made on the basis of actual receipts and disbursements? If not, describe fully what other basis or method was used in computing net income.—Accrual Basis.

Valuation of Inventories

8. State whether the inventories at the beginning and end of the taxable year were valued at cost, or cost or market, whichever is lower. If other basis was used, describe fully, state why used and the date inventory was last reconciled with stock.

List of Attached Schedules

9. Enter below a list of all schedules accompanying this return, giving for each a brief title and the schedule number. The name and address of the corporation should be placed on each separate schedule accompanying the return.

The corporation's books are in care of Chandis Securities Co. Located at 100 No. Broadway, Los Angeles, Cal.

CHANDIS SECURITIES COMPANY

INCOME TAX—1929

OTHER INCOME

Schedule 10-A

Belridge Oil Company.....	\$17,702.91
Midway Gas Company.....	31.54
Oak Knoll Property.....	4,650.00
Recovery of Bad Debts—Sam H. Thompson.....	500.00
Franklin Booth	1,800.00
Gold recovered from Minas Unidas.....	346.46
Globe Ice Cream Company.....	350.00
Rowland Cattle Company.....	570.24
	<hr/>
	<u>\$25,951.15</u>

CHANDIS SECURITIES COMPANY

INCOME TAX—1929

Schedule “22-A”

Salaries and Wages

Norman Chandler	\$ 1,200.00
Helen Chandler	245.00
	<hr/>
	<u>\$ 1,445.00</u>

Schedule “22-F”

Losses

California Cyanide Co.....	\$15,010.00
L. A. Suburban Homes Co.....	28,888.70
La Cumbre Mine.....	259.70
Minas Unidas	181.11
	<hr/>
	<u>\$44,339.51</u>

CHANDIS SECURITIES COMPANY

INCOME TAX—1929

DIVIDENDS RECEIVED

Schedule "H"

Central Investment Company.....	\$ 7.00
Citizens National Trust & Savings Bank.....	2,380.00
District Bond Company.....	870.00
L. A. Athletic Club.....	60.00
L. A. Morris Plan Bank.....	400.00
Mortgage Guarantee Company.....	960.00
The Times-Mirror Company.....	108,882.00
Union Oil Co. of California.....	9.79
Shell Union Oil Corporation.....	2,611.00
Yosemite National Park Co.....	1,176.15
Playa Del Rey Heights Co.....	16,753.60
Southern Pacific Company.....	180.00
The Zeolite Company.....	80.00
Western Air Express.....	199.45
Title Insurance and Trust Company.....	500.00
L. A. First Nat'l. Trust & Savings Bank.....	246.40
Hydraulic Brake Company.....	1,200.00
Security First Nat'l. Trust & Savings Bank.....	271.04

 \$136,786.43

CHANDIS SECURITIES COMPANY

INCOME TAX—1929

SUNDRY EXPENSES

Schedule "22-C"

Operating Expenses—Trust #3706.....	\$4,661.37
El Tres Hermanos Ranch.....	918.91
Lots 24 and 25, Tract 8623.....	7.50
Hillhurst Park Lots.....	534.00
Forthman Lot 839—45 So. Olive St.....	193.40
Lots 47 and 48, Calipatria.....	65.13
Trust #3222 T. I. & T. Co.....	2.51
Trust #3270	8.33
Clark Lot—931—35 So. Olive St.....	258.75
Kellam Lot—926 So. Olive St.....	78.00
Lot 1, Normandie Hill.....	340.23
Trust #3269	6.25
A. S. Carr Bldg., Calexico, Calif.....	455.57
Imperial Valley Real Estate Allottment #17.....	5.00
Trust R-2946 (Kern County).....	6.25
Lot #2 Normandie Hill.....	97.24
927 No. Irving Blvd.....	52.69
Moses K. Chandler Property.....	250.00
Valley Blvd. and Almanor St.....	2.25
	<hr/>
	\$7,943.38
	<hr/>

CHANDIS SECURITIES COMPANY

INCOME TAX—1929

DEPRECIATION

Kind of Property	Date Acquired	Age When Acquired	Probable Life	Cost	Depreciation This Year	Depreciation Previous Years
Residence House Frame & Brick.....	1917	New	20 Years	\$ 46,138.19	\$2,306.91	\$27,495.46
Furniture and Fixtures.....	1917	New	10 "	21,229.13	1,557.07	19,672.06
Business Block—Calipatria.....	1921	6 Years	20 "	13,500.00	675.00	4,893.75
Brick Building, 933 So. Olive St.....	1922	New	20 "	11,078.89	553.95	3,323.70
Brick Building, 926 So. Olive St.....	1920	New	33½ "	15,000.00	450.00	3,600.00
Automobile—Cadillac Brougham.....	1927	Second Hand	5 Years	1,800.00	360.00	375.00
Brick Building—Calexico.....	1925	Unknown	14 "	37,500.00	2,812.50	8,437.50
Brick Building—1145 S. Hope St.....	1909	New	33½ "	6,170.85	185.13	3,520.24
Residence House 127 No. Irving Blvd.....	1929	Unknown	20 Years	5,023.58	188.39	—
				<u>\$157,440.64</u>	<u>\$9,088.95</u>	<u>\$71,317.71</u>

Page 4 of Return

SCHEDULE A—COST OF MANUFACTURING OR PRODUCING GOODS (See Instruction 2)
(Not filled in)

SCHEDULE B—PROFIT FROM SALE OF REAL ESTATE, STOCKS, BONDS, ETC. (See Instruction 8)

1. Kind of Property	2. Date Acquired	3. Amount Received	4. Depreciation Allowable Since Acquisition	5. Cost or Value As of March 1, 1913 Whichever Greater	6. Subsequent Improvements	7. Net Profit (Enter as Item 8)
Stock—Western Air Express	10-24-25	\$54,680.25	\$ —	\$4,000.—	\$ —	\$50,680.25
Stock—Western Air Express	10-24-25	10,462.90	—	600.—	—	9,862.90
Bonds—Golden State Woolen Mill	Various	6,750.—	—	6,524.12	—	225.88
		<u>71,893.15</u>		<u>11,124.12</u>		<u>60,769.03</u>

State how property was acquired.....

SCHEDULE C—COMPENSATION OF OFFICERS (See Instruction 12)

1. Name of Officer	2. Official Title	3. Time Devoted to Business	SHARES OF STOCK OWNED		6. Amount of Compensation (Enter as Item 12)
			4. Common	5. Preferred	
Harry Chandler	President	All necessary	20		\$12,000.—
Marian Otis Chandler	Secretary	All necessary	200		18,500.—
					30,500.—

SCHEDULE D—COST OF REPAIRS

(See Instruction 14)

1. Items	2. Amount (Enter as Item 14)	1. Items	2. Amount (Enter as Item 16)
Salaries and wages	\$	State, County-City-Irrigation District Taxes	\$26,250.42
Building—933 So. Olive St.	1,770.74	State Franchise Tax	25.00
Building—926 So. Olive St.	1,591.77		
A. S. Carr Building—Calexico	1,182.67		
			26,275.42
	4,545.18		

SCHEDULE E—TAXES PAID

(See Instruction 16)

SCHEDULE F—EXPLANATION OF LOSSES BY FIRE, STORM, ETC. (See Instruction 17)

(Not filled in)

SCHEDULE G—BAD DEBTS

(See Instruction 18)

SCHEDULE H—DIVIDENDS DEDUCTIBLE

(See Instruction 19)

1. Year	2. Sales on Account	3. Bad Debts	1. Name of Corporation	Amount of Dividends	
				2. Domestic	3. Foreign
Cal. Cyanide Co.....	No Assets	\$3,900.—	(See Separate Schedule)		
Eugene Gunning	" "	100.—			
M. Walters	" "	500.—			
		<hr/>			
		4,500.—			

SCHEDULE I—EXPLANATION OF DEDUCTION FOR DEPRECIATION (See Instruction 20)

(See Separate Schedule)

AFFIDAVIT

We, the undersigned, president and treasurer of the corporation for which this return is made, being severally duly sworn, each for himself deposes and says that this return, including the accompanying schedules and statements, has been examined by him and is, to the best of his knowledge and belief, a true and complete return made in good faith, for the taxable year stated, pursuant to the Revenue Act of 1928 and the Regulations issued thereunder.

HARRY CHANDLER

President

[Corporate

Seal]

H. E. DOWNING

Asst.

Sworn to and subscribed before me this 15 day of March, 1930.

[Notarial

Seal]

ARTHUR CRUM,

(Signature of officer administering oath)

Notary Public in and for the County of Los Angeles,
State of California.

[Endorsed]: No. 9735. United States Circuit Court of Appeals for the Ninth Circuit. George D. Martin, as Internal Revenue Agent in Charge for the Sixth United States Internal Revenue Collection District of California, Appellant, vs. Chandis Securities Company and H. E. Downing, as Assistant Secretary of Chandis Securities Company, Appellees. Transcript of Record. Upon Appeal from the District Court of the United States for the Southern District of California, Central Division. Filed February 3, 1941. Paul P. O'Brien, Clerk of the United States Circuit Court of Appeals for the Ninth Circuit.

In the United States Circuit Court of Appeals
for the Ninth Circuit

No. 9735

GEORGE D. MARTIN, as Internal Revenue Agent
in Charge for the Sixth United States Internal
Revenue Collection District of California,
Petitioner and Appellant,

vs.

CHANDIS SECURITIES COMPANY and H. E.
DOWNING, as Assistant Secretary of Chandis
Securities Company,
Respondents and Appellees.

STATEMENT OF POINTS ON WHICH AP-
PELLANT INTENDS TO RELY AND DES-
IGNATION OF PARTS OF THE RECORD
NECESSARY FOR THE CONSIDERA-
TION THEREOF.

The appellant states that he intends to rely upon the points mentioned in the Statement of Points on Appeal filed in the District Court and found at pages 216 to 219, inclusive, of the Record upon Appeal herein.

The appellant designates the following parts of the record which he thinks necessary for the consideration of the points relied upon by him in this appeal:

Pages 2 to 11, inclusive, of the record, consisting of a Petition for Production of Records and Exhibits "A", "B" and "C" thereto attached; but omitting pages 12 to 24, inclusive, of the record, consisting of a Memorandum of Points and Authorities attached to the foregoing Petition and marked Exhibit "D".

Pages 26 to 28, inclusive, of the record, consisting of an Order for Production of Records.

Pages 30 and 31 of the record, consisting of Orders continuing the return date of the Order for Production of Records.

Pages 33 to 56, inclusive, of the record, consisting of a Notice of Motion to Quash the Order for Production of Records, the supporting affidavit of H. E. Downing (pages 38 to 46, inclusive, of the record); letter of reply (page 48 of the record); copy of Summons Duces Tecum (pages 49 and 50 of the record); letter of H. E. Downing to George D. Martin (page 51 of the record); Stipulation of Facts (pages 52 to 56, inclusive, of the record).

Print pp. 92-110.

Omit pages 57 to 129, inclusive, of the record, (consisting of the Opinion of the Board of Tax Appeals, pages 92 to 98, inclusive, of the record; Findings of Fact and Opinion, pages 99 to 105, inclusive, of the record; Commissioner's letter of final determination, pages 106 to 129, inclusive, of the record).

Pages 131 to 133, inclusive, of the record, con-

sisting of the affidavit of Charles W. Donnally dated May 4, 1940.

Pages 134 to 185, inclusive, of the record, consisting of the affidavit of Warner E. Williams (pages 134 to 137, inclusive, of the record); and the exhibits thereto defined as follows: Exhibit 1, letter dated November 25, 1931, (pages 138 to 144, inclusive, of the record) but omitting lines 16 to 24, inclusive, on page 140; Exhibit 2, protest to Internal Revenue Agent (pages 145 and 146 of the record); Exhibit 3, letter dated March 28, 1932, (pages 147 and 148 of the record); Exhibit 4, letter dated April 4, 1932, pages 149 to 151, inclusive, of the record); Exhibit 5, memo from George M. Thompson (pages 152 to 156, inclusive, of the record); Exhibit 6, income tax return of Marion Otis Chandler for 1929 (pages 157 to 163, inclusive, of the record); but omitting page 163 from the printed record. Exhibit 7, income tax return of Marion Otis Chandler for 1930 (Pages 164 to 173, inclusive, of the record); Exhibit 8, waiver of Mrs. Chandler found on page 174 of the record to be omitted from the printed record; Exhibit 9, corporation income tax return of Chandis Securities Company for 1923 (pages 175 to 185, inclusive, of the record; but omitting from the printed record Schedules "A", "B", "F" and "I" of page 176 and all of page 180 of the record except the affidavit thereon.

Page 186 of the record, consisting of an Order continuing the hearing on the return date of subpoena.

Pages 187 to 190, inclusive, of the record, consisting of an affidavit of H. E. Downing.

Page 192 of the record, consisting of an Order continuing the hearing on the return date of subpoena.

Pages 193 to 198, inclusive, of the record, consisting of an affidavit of Charles W. Donnally.

Pages 200 and 201 of the record, consisting of an affidavit of Warner E. Williams.

Pages 203 and 204 of the record, consisting of a counter-affidavit of H. E. Downing.

Page 206 of the record, consisting of Order of June 10, 1940, granting the Motion to Quash Order for Production of Records.

Pages 207 to 211, inclusive, of the record, consisting of the Opinion of the District Court.

Page 213 of the record, consisting of Notice of Appeal.

Page 215 of the record, consisting of Order extending time to docket record on appeal.

Pages 216 to 219, inclusive, of the record, consisting of Statement of Points on appeal, but omitting lines 30 to 32, inclusive, on page 218 and lines 1 to 17, inclusive, on page 219 from the printed record.

All orders extending the time to docket record on appeal granted by the Appellate Court.

Certificate of the Clerk of the United States District Court.

Statement of Points upon which appellant will

rely and designation of record by appellant entitled in the Circuit Court of Appeals.

Dated: This 29th day of January, 1941.

WM. FLEET PALMER—E. H.

United States Attorney

E. H. MITCHELL—E. H.

Asst. U. S. Attorney

EUGENE HARPOLE

Special Attorney,

Bureau of Internal Revenue.

SAMUEL TAYLOR—E. H.

Special Attorney,

Bureau of Internal Revenue.

Attorneys for Petitioner and

Appellant.

Receipt of two copies of the foregoing Statement of Points on which Appellant intends to rely and Designation of Parts of the Record Necessary for the Consideration Thereof are acknowledged this 29 day of January, 1941.

A. CALDER MACKAY,

T. B. COSGROVE,

F. J. O'NEIL,

F. B. YOAKUM, JR.,

By F. B. YOAKUM, JR

Attorneys for Respondents
and Appellees.

[Endorsed]: Filed Feb. 3, 1941. Paul P. O'Brien,
Clerk.

[Title of Circuit Court of Appeals and Cause.]

DESIGNATION BY APPELLEES OF ADDITIONAL PORTIONS OF RECORD MATERIAL TO CONSIDERATION OF APPEAL

To Honorable Paul P. O'Brien, Clerk of the above entitled Court, and to George D. Martin, as Internal Revenue Agent in Charge for the Sixth United States Internal Revenue Collection District of California, Petitioner and Appellant, and to his Attorneys, Wm. Fleet Palmer, E. H. Mitchell, Eugene Harpole and Samuel Taylor:

You and each of you will please take notice that under and pursuant to the provisions of Rule 19(6) of the Rules of Practice of the above entitled court, respondents and appellees designate the following additional portions of the record deemed material to a consideration of the appeal which respondents and appellees request be included in the printed record:

1. Pages 92 to 110, inclusive, of the Record; consisting of Exhibits 6, 7 and 8, which are attached to the Affidavit of H. E. Downing dated March 19, 1940.

2. Pages 131 to 133, inclusive, of the Record; being Affidavit of Charles W. Donnally dated April 5, 1940.

3. Page 163 of the Record; being a part of Exhibit 6 attached to the Warner E. Williams affidavit dated April 6, 1940.

Material to Consideration of Appeal is hereby acknowledged this 11th day of March, 1941.

WM. FLEET PALMER,
United States Attorney

E. H. MITCHELL,
Assistant United States At-
torney

EUGENE HARPOLE,
Special Attorney
Bureau of Internal Revenue

SAMUEL TAYLOR,
Special Attorney
Bureau of Internal Revenue

By EUGENE HARPOLE

M.

Attorneys for Petitioner and
Appellant

[Endorsed]: Filed March 13, 1941. Paul P.
O'Brien, Clerk.

No. 9735.

2

IN THE

United States Circuit Court of Appeals FOR THE NINTH CIRCUIT

GEORGE D. MARTIN, as Internal Revenue Agent in charge
for the Sixth United States Internal Revenue Collection
District of California,

Appellant,

vs.

CHANDIS SECURITIES COMPANY and H. E. DOWNING,
as assistant secretary of Chandis Securities Company,

Appellees.

SECOND BRIEF FOR APPELLANT.

SAMUEL O. CLARK, JR.,

Assistant Attorney General.

HELEN R. CARLOSS,

FRANK J. READY,

Special Assistants to the Attorney General.

Department of Justice, Washington, D. C.

WILLIAM FLEET PALMER,

United States Attorney.

E. H. MITCHELL,

Assistant United States Attorney.

EUGENE HARPOLE,

*Special Attorney, Bureau of
Internal Revenue.*

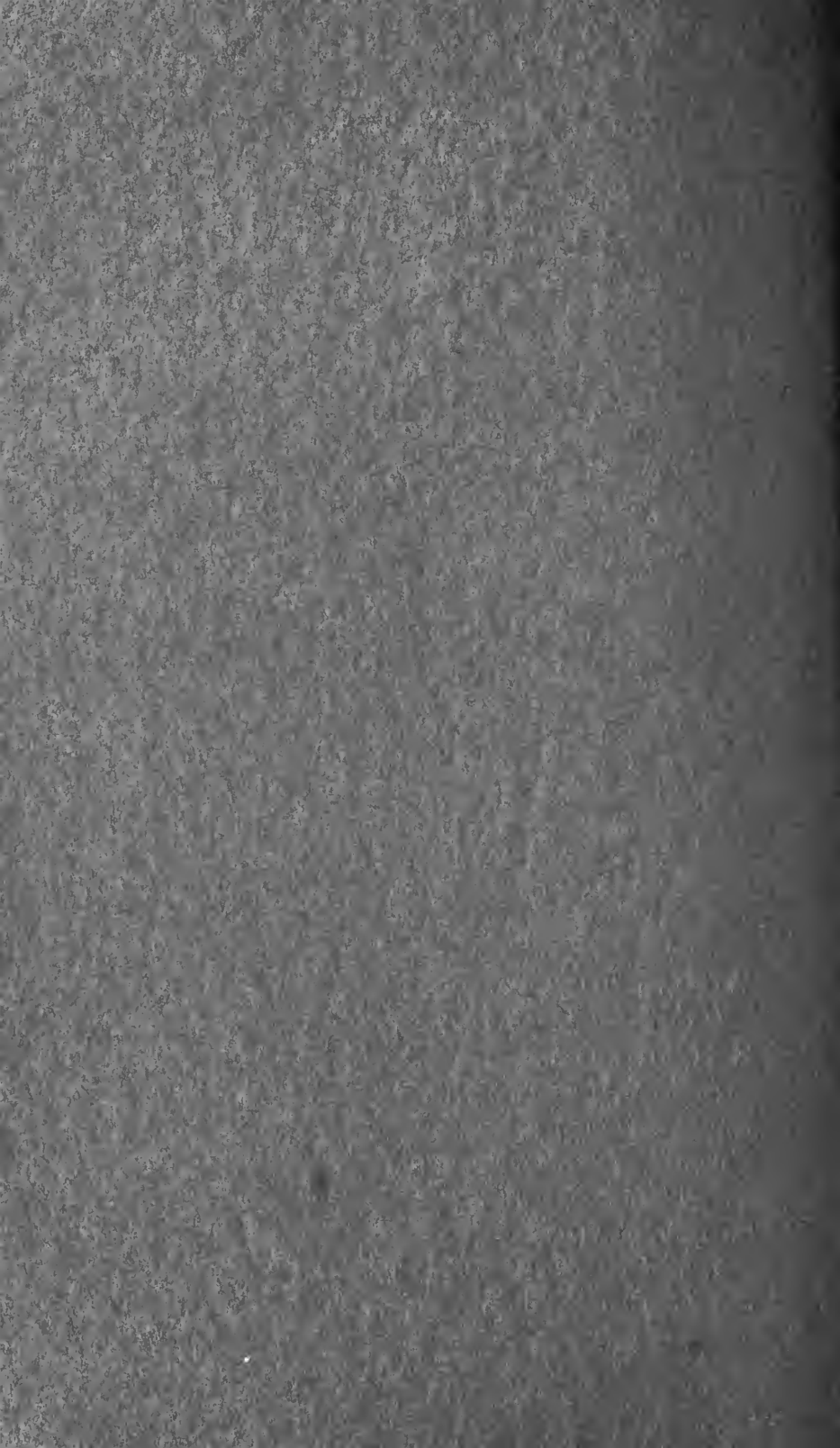
SAMUEL TAYLOR,

*Special Attorney, Bureau of
Internal Revenue.*

FILED

MAR 17 1942

PAUL P. O'BRIEN,
CLERK



TOPICAL INDEX.

	PAGE
Statement of the pleadings, facts and procedural steps disclosing jurisdictions.....	1
(a) Jurisdiction of District Court.....	2
(b) Jurisdiction of this court.....	5
Statement of the case.....	7
Questions presented	7
Statutes and court rules involved.....	9
Statement of the facts.....	9
Further showing of basis for relief, proceedings at hearing, and finality of district court's decision.....	16
Specification of errors and points to be urged.....	24
Summary of argument.....	26
Argument.....	29

I.

The District Court had jurisdiction under the provisions of section 3633, Internal Revenue Code, to grant the relief prayed in the petition.....	29
--	----

II.

The order and judgment entered by the District Court on June 10, 1940, is a "final decision" by that court which is subject to review on an appeal taken therefrom to the Circuit Court of Appeals for the Ninth Circuit within the purview of section 128(a) of the Judicial Code as amended.....	33
--	----

III.

The commissioner made a sufficient showing of probable cause, sometimes called reasonable grounds for suspicion of fraud, to justify his requested reexamination of the appellee corporation's books and records reflecting its transactions with the stockholder taxpayer herein involved..... 40

IV.

Neither the appellee corporation nor its assistant secretary is in a position to raise any question in this proceeding as to whether the commissioner's requested examination of its corporate records of transactions with its chief stockholder is unreasonable, unnecessary or futile because of the limitation against assessment of a deficiency, where the taxpayer is not before the court and, concededly, cannot be bound by any determination herein..... 55

V.

The commissioner should not be limited in his examination either as to particular books and records of the appellee corporation or as to the time of transactions leading up to or forming part of those between the taxpayer and the corporation which are now in question by reason by such transactions having occurred prior to any fixed, arbitrary date..... 58

Conclusion..... 62

Appendix:

Internal Revenue Code—

Section 3614	65
Section 3631	65
Section 3633	66
Section 3740	66

Judicial Code, as amended—

Section 128(a)	66
----------------------	----

Revenue Act of 1928, c. 852, 45 Stat. 791—

Section 275	67
Section 276	67

Rules of Civil Procedure for the District Courts of the United States—

Rule 1	67
Rule 7	67
Rule 10	68
Rule 12	68
Rule 39	68
Rule 56	68

TABLE OF AUTHORITIES CITED.

CASES.	PAGE
Andrews' Tax Liability, In re, 18 Fed. Supp. 804 (Md.).....	41
Atlas Beverage Co. v. Minneapolis Brewing Co., 113 Fed. (2d) 672 (C. C. A. 8).....	54
Bray v. Staples, 180 Fed. 321 (C. C. A. 4).....	38
Brownson v. United States, 32 Fed. (2d) 844 (C. C. A. 8).....	31
Caplis v. Helvering, 4 Fed. Supp. 181 (E. D. N. Y.).....	56
Chandler v. Commissioner, 16 B. T. A. 1248.....	10, 55
Chandler v. Commissioner, 32 B. T. A. 720.....	14, 50, 55
City of Eau Claire v. Payson, 107 Fed. 552 (C. C. A. 7).....	39
Commissioner v. Chandler, 89 Fed. (2d) 332 (C. C. A. 9).....	15, 55
Gregory v. Helvering, 293 U. S. 465.....	61
Griffiths v. Commissioner, 308 U. S. 355.....	61
Higgins v. Smith, 308 U. S. 473.....	61
Keegan, In re, 18 Fed. Supp. 746 (S. D. N. Y.).....	41, 56
Lucking v. Dalano, 122 Fed. (2d) 21 (App. D. C.).....	54
Lyons, In re, 32 F. Supp. 92 (E. D. N. Y.).....	32
McCrone v. United States, 307 U. S. 61.....	32
McMann v. Securities and Exchange Commission, 87 Fed. (2d) 377 (C. C. A. 2).....	45
Norton, Ex parte, 108 U. S. 237.....	38
Pelelas v. Caterpillar, Tractor Co., 113 F. (2d) 629 (C. C. A. 7)	19
Potter v. Beal, 50 Fed. 860 (C. C. A. 1).....	39
Schneiderman v. United States, 119 Fed. (2d) 500 (C. C. A. 9)	54
Simmons v. Peavy-Welsh Lumber Co., 113 F. (2d) 812 (C. C. A. 5)	19
Thomas v. Peyser, 118 Fed. (2d) 369 (App. D. C.).....	54

United States v. American Exchange Irving Trust Co., 43 Fed. (2) 829 (S. D. N. Y.).....	57
United States v. First Capital Nat. Bank, 89 Fed. (2d) 116 (C. C. A. 8).....	57
Upham's Income Tax, In re, 18 Fed. Supp. 737 (S. D. N. Y.)	41, 56
Wyant v. Crittenden, 113 Fed. (2d) 170 (App. D. C.).....	54
Zimmermann v. Wilson, 16 A. F. T. R. 1070 (E. D. Pa.).....	41
Zimmermann v. Wilson, 81 Fed. (2d) 847.....	41
Zimmermann v. Wilson, 105 Fed. (2d) 583 (C. C. A. 3).....	40, 44, 56

STATUTES.

Federal Rules of Civil Procedure for the District Courts of the United States, Rule 1.....	36
Federal Rules of Civil Procedure for the District Courts of the United States, Rule 7(c).....	37
Federal Rules of Civil Procedure for the District Courts of the United States, Rule 10(c).....	19
Federal Rules of Civil Procedure for the District Courts of the United States, Rule 12(b) (6).....	37
Federal Rules of Civil Procedure for the District Courts of the United States, Rule 12(c).....	37
Federal Rules of Civil Procedure for the District Courts of the United States, Rule 39(b).....	37
Federal Rules of Civil Procedure for the District Courts of the United States, Rule 56(b).....	37
Internal Revenue Code, Sec. 1112.....	56
Internal Revenue Code, Sec. 3614.....	4, 30, 32
Internal Revenue Code. Sec. 3631	3, 30
Internal Revenue Code, Sec. 3633	4, 31

	PAGE
Internal Revenue Code, Sec. 3740	4, 32
Internal Revenue Code (U. S. C., Supp. V, Title 26), Sec. 3901	
(a) (1)	2, 30
Internal Revenue Code, Sec. 4000.....	2
Internal Revenue Code, Sec. 4001.....	2
Judicial Code, Sec. 128(a).....	6, 24, 26, 38, 39, 63
Revenue Act of 1926, Sec. 1105, c. 27, 44 Stat. 9.....	3, 30
Revenue Act of 1928, Sec. 112(b) (5), c. 852, 45 Stat. 791....	
.....	13, 48
Revenue Act of 1928, Sec. 275(a).....	14, 48
Revenue Act of 1928, Sec. 276(a).....	14, 49, 55
Statutes and Amendments to the Codes, California, 1917, c. 532	
(Act of May 18, 1917), p 673.....	13
United States Codes, Supp. V, Title 26, Sec. 1112.....	56

No. 9735.

IN THE

United States Circuit Court of Appeals

FOR THE NINTH CIRCUIT

GEORGE D. MARTIN, as Internal Revenue Agent in charge
for the Sixth United States Internal Revenue Collection
District of California,

Appellant,

vs.

CHANDIS SECURITIES COMPANY and H. E. DOWNING,
as assistant secretary of Chandis Securities Company,

Appellees.

BRIEF FOR APPELLANT.

Statement of the Pleadings, Facts and Procedural Steps Disclosing Jurisdictions.

This case arises on appeal from an order and judgment entered by the District Court of the United States for the Southern District of California, Central Division. [R. 157-159.] The opinion, by Judge Yankwich [R. 152-157], is reported in 33 F. Supp. 478.

The facts and matters disclosing the basis upon which it is contended that the District Court had jurisdiction to grant the relief sought in this proceeding, as disclosed by the petition and the affidavits and exhibits submitted in support thereof at the hearing [R. 2-13, 73-78, 148-149] are summarized below; the proceedings had both prior and

subsequent to the entry of the order and judgment from which this appeal was taken, and which are relied upon as the basis for invoking the jurisdiction of this Court to review that order and judgment, are briefly outlined; and the statutory provisions believed to sustain both jurisdictions are briefly referred to. These are all as follows:

(a) JURISDICTION OF DISTRICT COURT.

Appellant, who was petitioner in the court below, is the United States Internal Revenue Agent in Charge in and for the Sixth Internal Revenue Collection District with office and post of duty in the City of Los Angeles, California. He is the Internal Revenue agent and field officer of the Bureau of Internal Revenue who is designated and authorized by the Commissioner of Internal Revenue to make the investigation of tax liability herein involved. [R. 2-3, 8-9.]¹

The appellee, Chandis Securities Company (hereinafter referred to as Chandis) is a private family corporation domiciled in the City of Los Angeles, California [R. 3-4], whose entire outstanding capital stock is owned by the family of Harry Chandler in the proportion of 40% by Mrs. Marian Otis Chandler (the taxpayer), 56% divided

¹Internal Revenue Code (U. S. C., Supp. V, Title 26), Sec. 3901(a)(1) provides that the Commissioner of Internal Revenue, under the direction of the Secretary of the Treasury "shall have *general superintendence* of the assessment and collection of all taxes imposed by any law providing internal revenue." (Italics supplied.)

Section 4000 thereof also provides that the Commissioner may, whenever in his judgment the necessities of the service so require, employ competent agents who shall be known as internal revenue agents, and Section 4001 thereof provides further that—

The Commissioner may, at his discretion, assign any agent whose employment is authorized by the preceding section to duty under the direction of any officer of the internal revenue, or to such other duty as he may deem necessary.

equally among the eight Chandler children and 4% by Mr. Chandler. [R. 51-57.]

The appellee, H. E. Downing, is the assistant secretary of Chandis, has his office and residence in the City of Los Angeles, California, and also is the custodian of the books, records and papers sought to be examined herein. [R. 4, 24.] He is also asserted to have knowledge of certain business transactions of Mrs. Marian Otis Chandler affecting her individual income tax liability for the year 1930 now under inquiry by the Bureau of Internal Revenue. [R. 4, 12-13, 73-78, 148-149.]

The taxpayer is not a party to this proceeding.

On March 31, 1938, the acting Commissioner of Internal Revenue addressed to the taxpayer, Marian Otis Chandler, a written request for a re-examination of her books and records for the reason that it was deemed necessary in order to properly verify her income tax return for the year 1930 [R. 9] and caused the same to be delivered to her by a local internal revenue agent on November 30, 1939. [R. 25.] This action was taken pursuant to the provisions of Section 1105 of the Revenue Act of 1926 (now Section 3631, Internal Revenue Code, Appendix, *infra*). The taxpayer refused and still refuses to comply with the Commissioner's request. [R. 25, 34-35.]

The Commissioner designated appellant and his assistants or the internal revenue agents working under his immediate supervision as the officers or employees of the field service of the Bureau of Internal Revenue who should on his behalf examine "any books, papers, records,"

etc., for the purpose of ascertaining the correctness of the taxpayer's return and who should require the attendance and testimony of any person "having knowledge in the premises." This designation was made pursuant to the provisions of Section 3614, Internal Revenue Code (Appendix, *infra*).²

Acting under such authority and direction, in the name of the Commissioner of Internal Revenue and pursuant to the provisions of said Section 3614 of the Internal Revenue Code, appellant on November 30, 1939, issued and caused to be duly served upon the appellees a written instrument entitled "Summons to Appear to Testify and to Produce Books, etc.," requiring them to appear before him at a designated place on December 11, 1939, to then and there give testimony in the matter of the taxpayer's 1930 income tax liability, and to produce certain records therein described. [R. 4-5, 10-11.] Appellees refused to respond to such summons. [R. 6-7.]

On March 5, 1940, this proceeding was commenced in the District Court pursuant to the provisions of Section 3633 of the Internal Revenue Code (Appendix) to compel such attendance, testimony and production of records. [R. 2-13.] The petition was filed with the authority and sanction of the Commissioner of Internal Revenue and at the request of the Attorney General of the United States. [R. 2-3.] That was done under the authority granted by Section 3740, Internal Revenue Code (Appendix, *infra*).

²In acting Commissioner Carter's letter to the taxpayer which he caused to be personally served upon her by local internal revenue agents acting under appellant's immediate supervision as just pointed out, he asks the taxpayer to "permit our representatives to have access to all your books and records" and to "cooperate fully with them" in the requested re-examination. [R. 9.]

(b) JURISDICTION OF THIS COURT.

In his petition appellant prayed that an order issue requiring appellees to appear at the place designated on March 11, 1940, to testify and to produce the records listed in said summons. [R. 7-8.]³ No other relief was sought. An order, as so prayed, was issued *ex parte* on March 5, 1940. [R. 13-16.] The return date was, by court order, duly continued to April 8, 1940 [R. 16-18], and appellees made a timely motion to quash such order. [R. 19-24.] Affidavits in support of the motion to quash [R. 24-37, 136-140, 150-151] with voluminous exhibits thereto [R. 37-73, 165-221, 222-256] were submitted to the District Court by the appellees, and counter-affidavits in opposition to that motion and in support of the petition and order theretofore issued thereon [R. 9-13, 73-79, 141-149] and exhibits attached thereto [R. 80-135] were submitted by appellant.

On June 10, 1940, the District Court filed its memorandum opinion (1) holding that appellant was not entitled to any relief against appellees under the petition and supporting affidavits; and (2) directing that the *ex parte*

³The list of records set forth in that summons [R. 10-11] and copied into the petition [R. 5] is as follows:

Records of Chandis Securities Company for the years 1916 to 1930, inclusive, as follows: Minute books; capital stock certificate books, ledgers and journals; all accounting books and records including general ledgers, together with all vouchers, correspondence and other written data supporting the original entries in said accounting books; all promissory notes of Chandis Securities Company issued, assigned, endorsed, or otherwise transferred during said years to Marian Otis Chandler, Franceska Chandler Kirkpatrick, May Chandler Goodan, Helen Chandler, Philip Chandler, Ruth Chandler Williamson, Harrison Gray Chandler, Constance Chandler, and Norman Chandler which have been paid or otherwise cancelled,

order for production of records be quashed and annulled “without prejudice * * * to a new application upon a new petition” and upon a proper showing limited both in point of time and to matters required to be included in the return of the taxpayer “with special reference to the particular transaction * * * under investigation.” [33 F. Supp. 478; R. 152-157.]

The order and judgment entered by the District Court to the same effect on the same date [R. 151-152] is the one from which this appeal is taken. [R. 157-158.]

Appellant served and filed notice of appeal from that decision to the Circuit Court of Appeals for this Circuit on September 6, 1940. [R. 157-159.] The District Court on October 4, 1940, extended the time for filing the record in this Court and docketing the cause on appeal to and including December 5, 1940. [R. 159.]

All further necessary extensions were obtained under timely orders, signed and entered by judges of this Court on December 5, 1940, February 1, 1941, and February 24, 1941, respectively, in order to render timely (1) the service and filing of appellant’s statement of points on appeal on December 31, 1940 [R. 160-162], (2) the settlement and certification of the record in the court below [R. 258-266], and (3) the filing of the transcript of the record of the District Court in this Court and the docketing of the cause on appeal here on February 3, 1941. [R. 257.]

The jurisdiction of this Court to review the decision of the trial court upon this appeal is invoked under Section 128(a) of the Judicial Code, as amended (Appendix *Infra*, p. 66).

STATEMENT OF THE CASE.

Questions Presented.

The first two questions presented have been raised by this Court upon its own motion at a former hearing of this cause on February 24, 1942, although not noticed in the appellees' brief. They involve the jurisdictions of both the District Court and of this Court, respectively, and are as follows:

1. Did the District Court have jurisdiction under the provisions of Section 3633, Internal Revenue Code, to grant relief of the nature prayed in the petition?

2. Is the order and judgment entered by the District Court on June 10, 1940, a "final decision" by that Court which is subject to review on an appeal taken therefrom to the United States Circuit Court of Appeals for the Ninth Circuit within the purview of Section 128(a) of the Judicial Code as amended?

The other three questions involve the merits and arose in this manner. Acting through appellant as his designated field representative, the Commissioner of Internal Revenue sought judicial process for the enforcement of an administrative summons and subpoena *duces tecum* enabling him to make a second examination of the books and records of a family holding corporation. The Commissioner's purpose was twofold: *first*, to ascertain whether there was actual fraud in the failure of the principal shareholder in the corporation to include in her individual income tax return for the calendar year 1930 a large amount of interest previously accrued upon promissory notes of the corporation and paid to the taxpayer through

the culmination in 1930 of a series of transactions between the corporation and its shareholders which extended over a long period of years antedating that taxable year, and *second*, if he found fraud had existed, and hence that the assessment of a deficiency for that year was not barred by the statute of limitations, to determine whether and to what extent a tax deficiency should be proposed against the shareholder upon the basis of the asserted interest income for that year. [R. 2-13.] The District Court, after a hearing and submission upon all the issues raised by the respective parties under the form of procedure hereinbefore described, held that appellant was not entitled to any relief under the petition herein but without prejudice to the right of appellant to commence a new proceeding by filing a new petition seeking relief of a more limited nature than sought herein. [R. 151-152.] The questions thereby presented are as follows:

3. Did the Commissioner make a sufficient showing of probable cause, sometimes called reasonable grounds for suspicion of fraud, to justify his requested re-examination of the appellee corporation's books and records reflecting its transactions with the stockholder taxpayer herein involved?

4. Is either the appellee corporation or its assistant secretary in a position to raise any question in this proceeding as to whether the Commissioner's requested examination of its corporate records of transactions with its chief stockholder is unreasonable, unnecessary, or futile because of the limitation against assessment of a deficiency, where the taxpayer is not before the Court, and, concededly, cannot be bound by any determination herein?

5. Should the Commissioner be limited in his examination either as to particular books and records of the appellee corporation or as to any transactions leading up to or forming part of those between the taxpayer and the corporation which are now in question, by reason of such transactions having occurred prior to any fixed, arbitrary date?

Statutes and Court Rules Involved.

These are set forth in the Appendix, *infra*, pages 65-68.

Statement of the Facts.

Undisputed Historical Facts.

In 1916, Harry Chandler organized the appellee Securities Company as a family holding corporation domiciled in California with original authorized capital stock of 500 shares aggregating the par value of \$500,000. He caused 40% of its stock to be issued to his wife (the taxpayer here), and 56% in equal proportions to his eight children. Shortly thereafter Mr. Chandler transferred certain investment properties to the corporation in consideration of its interest-bearing promissory notes and assigned the notes to his wife and children in proportion to their shareholdings in the corporation. [R. 50-51, 58-61.]

On December 31, 1923, when the principal sum of all the notes so assigned amounted to \$1,938,548.60, and interest had accrued thereon of \$702,049.61, aggregating \$2,640,598.21, the first series of notes was surrendered and new notes were issued by the appellee corporation to Mrs. Chandler and the children, respectively, in principal

sums aggregating \$2,640,598.21. The new notes were to mature December 31, 1929, and bore interest at 5% per annum, compounded annually. [R. 31-53.] Under that arrangement the taxpayer cancelled and surrendered old notes for the total principal sum of \$810,687.06 upon which interest of \$294,950.76 had accrued to December 31, 1923, and received new interest-bearing notes for the aggregate principal sum of \$1,105,637.82. [R. 44-45, 51-53.] The new notes matured December 31, 1928. [R. 222-224.] The company kept its books upon the accrual basis, but did not accrue the interest upon the notes thus held by its stockholders as such interest originally became due yearly. However, in 1923, the company set up on its books the total amount of all such interest accumulated during the preceding six years. The taxpayer had made her returns during that same period upon the cash receipts and disbursements basis. [R. 60.]

When the Commissioner attempted to assess income tax against the shareholder payees of the first series of notes to the extent of interest thus included in the face of the new notes received by them on December 31, 1923, the Board of Tax Appeals on June 29, 1929, disallowed the proposed deficiencies for 1920-1923, holding that the payees of the new notes had not constructively received any interest income in the 1923 transaction. (*Chandler v. Commissioner*, 16 B. T. A. 1248.) [R. 58-67.]

Thereafter, when interest in the total sum of \$875,-008.67 had accrued to and including December 31, 1929, upon the second series notes for the total principal sum of

\$2,640,598.21, making aggregate principal and interest then due thereon of \$3,515,606.88, all of those notes were cancelled and surrendered, and the company issued 35,156 additional shares of its capital stock of the par value of \$100.00 each, aggregating \$3,515,600.00, to the respective payees of those notes in full settlement of the indebtedness for principal and interest represented by its notes. [R. 52-57.]

Under that arrangement the taxpayer surrendered her notes dated December 23, 1923, for the aggregate principal sum of \$1,105,637.82, maturing December 31, 1928, upon which compound interest of \$366,418.80 had been accrued to December 31, 1929, aggregating \$1,472,056.62 [R. 45] and received and accepted 14,721 shares of stock of Chandis of the aggregate par value of \$1,472,100.00 [R. 45, 47] in full settlement of her notes and accrued interest thereon. [R. 52-57, 222-226.] The newly issued shares of stock were stipulated (in a former proceeding before the Board of Tax Appeals involving the taxpayer's 1929 tax liability and hereinafter mentioned) to be worth \$60.00 per share. [R. 55-56.]

From 1924 to 1929, inclusive, Chandis accrued the prescribed interest upon this second series of its notes and deducted that interest upon its annual income tax returns for those years. [R. 55.] The individual shareholders constituting the ultimate payees of both series of notes kept their books and made their returns of annual income upon the cash receipts and disbursements basis. Those

individuals never reported any item of interest from this source as taxable income, nor have they ever paid any tax upon any interest income of this nature. Chandis has deducted from its returned gross income corresponding amounts as interest expense for all the years 1918 to 1929, inclusive. [R. 55, 59-67.] However, Chandis never charged itself upon its books with any interest accruing upon those notes after December 31, 1929, and has never deducted any interest accruing upon those notes after that date from its reported gross income for any taxable year. [R. 200.]

The taxpayer filed her individual income tax return for the calendar year 1929 on March 15, 1930 [R. 100], and filed her 1930 income tax return on March 16, 1931. [R. 112.]

On November 25, 1931, the taxpayer was furnished a copy of a report of an internal revenue agent recommending a deficiency assessment against her for the year 1929 upon the basis, *inter alia*, that she had received unreported interest income during that year from the transactions above described. [R. 78, 83-85.] On December 17, 1931, the taxpayer filed with the Internal Revenue Agent in Charge at Los Angeles her own affidavit admitting that Chandis had acquired its promissory notes just mentioned from her "*during the calendar year 1929*" but protesting upon grounds not material here that the transaction did not give rise to any taxable income to her during that period. [R. 87-89.] A supplementary letter was also sent to the Internal Revenue Agent in Charge by her representatives on March 28, 1932, merely amplifying her protest that the issuance of stock in payment of notes of

Chandis had not resulted in taxable income to the taxpayer. [R. 90-91.]⁴

The permit issued by the Commissioner of Corporations of California on December 26, 1929, under the laws of California⁵ granting application of Chandis to issue additional shares of stock for this purpose required that the exchange "should involve simultaneous cancellation of the notes and issue of stock—that the cancellation and issuance were to coincide in time." [R. 52-57.]

The former Internal Revenue Agent in Charge at Los Angeles acknowledged receipt of both of the taxpayer's communications by letter to the taxpayer dated April 4, 1932, stating the protests were being referred to the Bureau at Washington, D. C. He also clearly indicated that the field office was submitting the matter to Washington upon the basis that payment of the notes with shares of stock of Chandis was a taxable transaction consummated by the taxpayer *during the year 1929*. [R. 78, 92-94.]

On July 1, 1932, the Commissioner issued statutory sixty-day notice to the taxpayer of a deficiency in her 1929 income tax upon the basis that she had received unreported interest income from Chandis during that year of

⁴The taxpayer's only objection to the proposed deficiency for 1929 at that time was that the payment of the maker's promissory notes with shares of its own corporate stock was a nontaxable exchange under Section 112(b) (5) of the Revenue Act of 1928, c. 852, 45 Stat. 791. [R. 88, 91.]

⁵Statutes and Amendments to the Codes, California, 1917, c. 532 (Act of May 18, 1917), pp. 673, 679:

Sec. 12. *Securities void*. Every security issued by any company, without a permit of the commissioner authorizing the same then in effect, shall be void, and every security issued by any company, with the authorization of the commissioner but not conforming in its provisions to the provisions, if any, which it is required by the permit of the commissioner to contain, shall be void.

\$661,369.56 [R. 67, 69]; and the taxpayer appealed to the United States Board of Tax Appeals from that determination of deficiency.

The taxpayer's individual income tax return for the year 1930 had been filed on March 16, 1931, as already stated [R. 112], so that the two year statute of limitations for assertion of any tax deficiency for that year expired on March 16, 1933, in the absence of fraud.⁶

After the expiration of that time, and on September 25, 1933 [R. 173], the taxpayer filed an amended petition with the Board of Tax Appeals in her 1929 case setting up for the first time the contentions (a) that she had neither cancelled and surrendered her notes nor received any shares of stock therefor during the taxable year 1929; (b) that such transaction had been consummated as to both interested parties entirely in the year 1930; and (c) that the transaction could not give rise to taxable income to her during the year 1929 in any event. [R. 167, 201-202.] She then broadened her attack upon the proposed 1929 deficiency by adding other grounds not material herein. [R. 165-173.] Similar amended petitions were likewise filed with the Board in the companion cases of the taxpayer's eight children. Upon the hearing of the consolidated appeals the Board, on June 7, 1935, found that neither the cancellation and surrender of the notes nor the issuance of the additional shares of stock had taken place until 1930, and disallowed the proposed deficiencies without considering any other phase of that transaction.⁷ Upon appeal by the Commissioner, this Court affirmed the Board's decision

⁶Sections 275(a) and 276(a), Revenue Act of 1928, Appendix, *infra*.

⁷*Chandler v. Commissioner*, 32 B. T. A. 720. [R. 29, 50-57.]

without consideration of any question except the sufficiency of the evidence to sustain the Board's finding that the transaction was not consummated during the taxable year 1929.⁸

In the 1929 case, the Board made evidentiary findings (a) that the notes in question were in the custody of the appellee Downing (who was then secretary of Chandis) throughout the year 1929; (b) that the balance sheet of Chandis on December 31, 1929, listed the notes among its liabilities; (c) that the books of Chandis contained appropriate entries to show consummation of these transactions in 1930; (d) that the notes were surrendered and cancelled on January 2, 1930; (e) that the stock certificates were issued "on that day or later in that month, but as of January 2, 1930"; and (f) that the stock certificates were delivered in May, 1930. [R. 55-57.] The three cancelled notes put in evidence by the taxpayer before the Board and also stipulated into the record herein bear identical typewritten notations or endorsements across their face, signed by the taxpayer and reading as follows [R. 222-224]:

January 2, 1930

*The Receipt Of Capital Stock Of Chandis
Securities Company In Full Settlement
Of Principal and Accrued Interest To
December 31, 1929 Is Hereby Acknowledged.*

(Signed) MARIAN OTIS CHANDLER.

At the hearing of the taxpayer's 1929 case before the Board the appellee Downing testified as a witness in her

⁸*Commissioner v. Chandler*, 89 Fed. (2d) 332 (C. C. A. 9th). [R. 29.]

behalf. Upon cross-examination he admitted (a) that he had been with Chandis since its organization in 1916 and with the Chandler family since 1902; (b) that all the books and records of Chandis, together with its promissory notes above described, had been in his custody during the entire year 1929; (c) that all such books, papers and records were kept by him during that period in one safe which belonged to another corporation; and (d) that such safe had been kept in the offices of that other corporation in a room assigned to Downing for use in transacting the business of Chandis. [R. 196-197.]

Broadly speaking, the above described events and proceedings constituted the historical background and basis for the Commissioner's determination that it was necessary to re-examine into the individual income tax case of Mrs. Marian Otis Chandler for the year 1930 and to seek the aid of judicial process in that re-examination when the interested parties denied his representatives access to the pertinent records for that purpose. Other phases of the merits, including a direct and material issue of veracity as between Revenue Agent Donnally [R. 73-76, 141-147] and the appellee Downing [R. 136-140] are set forth hereinafter under the appropriate subheading.

**FURTHER SHOWING OF BASIS FOR RELIEF,
PROCEEDINGS AT HEARING, AND FINALITY
OF DISTRICT COURT'S DECISION.**

The events and proceedings subsequent to those just described are stated below without repetition of matters already referred to any further than necessary to show here the full picture presented to the trial court as follows:

Appellant duly served the taxpayer with the Commissioner's statutory written notice of the Commissioner's determination that it was necessary for his agents to make a re-investigation of her 1930 income tax case. [R. 9, 25.] The interested parties refused to submit to the requested examination of their records. [R. 6-7, 25, 34-45.] Appellant, acting in the Commissioner's name, and under his direction then issued and served upon appellees the administrative summons already described directing the submission for his examination of the books, papers and records listed in the margin under footnote 3, *supra*, and to testify relative thereto. [R. 5, 10-11.] Appellees refused to respond thereto. [R. 6-7.] Appellant then filed in the District Court on March 5, 1940, the petition herein, praying solely that appellees be ordered by the court to appear before appellant at his office at 10 o'clock A. M. on March 11, 1940, produce the same records and give the same testimony called for under the aforesaid summons and order. [R. 2-13.] On the same date the District Court issued an *ex parte* order as prayed. [R. 13-16.] Within the return day as extended [R. 16-18] appellees moved to quash that order. [R. 19-24.]

Technically and strictly speaking, the cause was heard and submitted upon a motion to quash the *ex parte* order. However, with at least the tacit approval of the trial court, the parties for all practical purposes undertook to submit the whole controversy to the trial court then and there for determination upon the merits. They presented numerous affidavits (some of which were violently conflicting as to material phases of the case) and voluminous documentary exhibits in support of their respective versions of the disputed factual matters as well as in explana-

tion of the historical background of the case which is largely a matter of record and not in dispute. [R. 24-256.]

These various affidavits and documents are summarized as follows:

The petition includes and is supported by an affidavit of Revenue Agent W. E. Williams, stating (1) that the Government was attempting to determine why certain asserted interest income received by the taxpayer from the appellee corporation in excess of \$650,000 had not been reported in her income tax return for the calendar year 1930; (2) that most of the facts in connection with the receipt of this asserted interest income, the manner of its accrual and its value at the date of receipt for taxation purposes are contained in the books and records of the appellee corporation; (3) that the appellee Downing has unusual personal knowledge of those transactions; and (4) that the requested administrative examination of those corporate books and records and oral examination of the appellee Downing is necessary "in order to determine" whether the taxpayer committed a fraud against the revenue by failing to report in her 1930 income tax return "a large sum of asserted interest income received by her" from the appellee corporation in the year 1930. [R. 12-13.]

At the hearing appellees submitted in their behalf (a) Downing's affidavit dated March 19, 1940 [R. 24-37] with voluminous exhibits thereto [R. 37-73]; (b) Downing's second affidavit filed April 19, 1940 [R. 136-140]; (c) Downing's "counter-affidavit" filed May 14, 1940 [R. 150-151], and (d) "Respondent's Exhibit A" consisting of amended pleadings and excerpts from the record in the

1929 case of the taxpayer [R. 165-221], and certain documents put in evidence before the Board of Tax Appeals in that proceeding. [R. 222-256.]

Appellant submitted at the hearing in his behalf (a) his own verification of the petition, the affidavit of Revenue Agent Williams just mentioned and other exhibits to the petition [R. 8-13]; (b) affidavit of Revenue Agent Donnally dated April 5, 1940 [R. 73-76]; (c) a second affidavit of Williams dated April 6, 1940 [R. 76-79], and exhibits thereto [R. 80-135]; (d) a second affidavit of Donnally filed May 3, 1940 [R. 141-147], and (e) a third affidavit of Williams filed May 10, 1940. [R. 148-149.]⁹

Under the various affidavits and exhibits thus submitted on the motion to quash, appellant made a showing of the existence of certain evidentiary facts material to the question of probable cause or reasonable ground for the Commissioner's suspicion of fraud in the taxpayer's 1930 income tax return (and without any serious attempt at contradiction by appellees) substantially as follows:

(a) A revenue agent acting under the Commissioner's direction made a field examination of the taxpayer's

⁹Under the Federal Rules of Civil Procedure for the District Courts of the United States, Rule 10(c) (Appendix, *infra*) the affidavits and documents made exhibits to the petition are "part thereof for all purposes," and more especially for the purpose of any hearing at which the sufficiency of the petition is involved. Cf. *Simmons v. Peavy-Welsh Lumber Co.*, 113 F. (2d) 812 (C. C. A. 5th); *Pelelas v. Caterpillar Tractor Co.*, 113 F. (2d) 629 (C. C. A. 7th). In view of the spirit and intent of these new rules, as specifically asserted in Rule 1 (also Appendix, *infra*) that "they shall be construed to secure the just, speedy, and inexpensive determination of every action," and the way the parties, with the benediction of the trial judge, submitted their respective evidence and legal contentions to the trial court in this somewhat unusual but nevertheless practical manner for this peculiar type of statutory proceeding, it is submitted that this Court may properly treat the decision now appealed from as one intended by the trial court and accepted by the parties as a final determination of the case in the District Court. This feature is further noticed in our argument hereinafter.

individual 1929 income tax return and submitted a report on or about November 25, 1931, recommending a deficiency assessment against her for that year upon the basis that the payment or settlement by the appellee corporation of its notes and interest due thereon with shares of its own stock had resulted in unreported taxable income to the taxpayer for that year. [R. 78, 80-85.]

(b) After the taxpayer received copy of that report she submitted a sworn protest dated December 17, 1931, to the former Internal Revenue Agent in Charge at Los Angeles and represented to the Bureau in her own affidavit that the transaction in question took place "during the calendar year 1929" but was merely a non-taxable or exempt exchange under the income tax laws. [R. 87-89.]

(c) Her representatives thereafter on March 28, 1932, and April 4, 1932, exchanged letters with the Internal Revenue Agent in Charge upon the same basis while her 1929 tax liability was still under consideration. [R. 90-93.] In his letter bearing the latter date, the Agent in Charge informed the representative of the taxpayer that the revenue agent's report and her protests regarding her 1929 case had been forwarded to the Commissioner at Washington "for consideration and appropriate action", and furnished her a recomputation of her 1929 tax liability as then recommended to the Bureau by the field office, treating the above transaction as having been consummated in 1929. [R. 92-94.]

(d) The Commissioner relied upon these representations of the taxpayer when on July 1, 1932, his statutory sixty-day deficiency notice was issued asserting she had

received unreported interest income of \$661,369.56 during that year from the same transaction. [R. 67, 69, 71.]

(e) After the taxpayer appealed to the Board of Tax Appeals from the deficiency thus proposed in 1932 for the year 1929, she delayed or waited until August, 1933, before her representatives notified counsel for the Bureau in that proceeding of her change in position from what was stated in her affidavit of December 17, 1931. [R. 201-202.] On September 25, 1933, she filed an amended petition with the Board asserting that the exchange of notes for stock was consummated during 1930 and hence in 1929 could not give rise to a deficiency for 1929. [R. 165-173.]

(f) By thus waiting or delaying until August, 1933, to give the Commissioner notice of that change in her position, she misled the Commissioner as to the vitally material fact whether the transaction in question was consummated in that taxable year or in a later one not then directly under consideration by the Bureau. As a result of being so misled by the taxpayer's own personal misleading statement of material facts, the Bureau relied upon that representation of material facts, until the Commissioner had lost the right to test out on the merits either before the courts or the Board of Tax Appeals under a timely asserted tax deficiency for the year 1930 the question whether the taxpayer had received over a half million dollars of asserted unreported interest income during either year. [R. 75-76; 80, 82-85; 87-89; 90-91; 67, 69-71; 201-202.]

As already indicated, an issue of veracity developed at the hearing as between the affidavits of Revenue Agent Donnally of April 5, 1940 [R. 73-76], and of May 2,

1940 [R. 141-147], and the affidavits of the appellee Downing of April 19, 1940 [R. 136-140], and of May 14, 1940 [R. 150-151].

Revenue Agent Donnally's first affidavit [R. 73-76] substantially is as follows:

(1) That while acting in his official capacity he made an investigation and report on the 1929 income tax liability of the taxpayer; (2) that in the course of that investigation and on or about September 15, 1931, he went to her residence in Los Angeles as given in her 1929 return and demanded to see her about that return; (3) that he was instructed at her residence to see the appellee Downing as the taxpayer's representative "with regard to her income tax returns", and was told that Downing would furnish whatever information Donnally desired respecting the same; (4) that he called upon the appellee Downing for that purpose; (5) that Downing informed Donnally he had charge, for the taxpayer, of matters pertaining to her income tax return and that Downing would answer any questions Donnally had with regard to her 1929 return; (6) that Agent Donnally then requested Downing to produce all the books and records and documents pertaining to the exchange by the taxpayer and by other members of the Chandler family of their notes owing by the appellee corporation for shares of its stock; (7) that Agent Donnally specifically requested Downing to produce the notes which were supposed to have been cancelled in exchange for stock; and (8) that in reply Downing stated [R. 75]—

that the notes had been in his possession for a long period prior to December 31, 1929; that the notes

had been cancelled in 1929 and that all legal steps had been taken for the issuance of the stock of the Chandis Securities Company prior to the close of 1929, but that the mechanical operation of issuing the certificates was delayed as the new certificates had not been received from the printer.

Revenue Agent Donnally states further in his affidavit that [R. 75]—

on several visits to the office of the Chandis Securities Company for the purpose of examining the 1929 income tax return of Marian Otis Chandler he repeatedly requested from Mr. Downing that said notes be produced and was repeatedly told by Mr. Downing that the notes had been misplaced and that Mr. Downing was unable to produce them, but was repeatedly assured by Mr. Downing that the notes were cancelled in 1929 and that if they were found they would so indicate on their face. * * *

And that [R. 75-76]—

he relied absolutely upon the statements of Mr. Downing that the notes had been misplaced and were not available, and that the notes had been cancelled in 1929 and would so indicate on their face if found, in preparing his recommendation to his superiors that the exchange of the notes for the stock was taxable in 1929.

Downing's affidavit of April 19, 1940 [R. 136-140], denies every material statement attributed to him in the

Donnally affidavit except that he had acted as Mrs. Chandler's representative in those interviews, and quotes from the transcript of his oral testimony given seven years earlier as a witness for the taxpayer at the hearing of her 1929 case before the Board of Tax Appeals. [R. 136-138.]

Conflicting statements were also presented at the hearing as between the affidavits of Revenue Agent Williams [R. 12-13, 76-79, and 148-149] and the affidavits of Downing [R. 24-37; and 150-151], as to the necessity for the Bureau to make the requested administrative examination into the taxpayer's 1930 income tax liability and the extent to which it should be limited, as will be developed hereinafter in the argument.

Specification of Errors and Points to Be Urged.

1. The District Court had jurisdiction to grant relief of the nature prayed in the petition.

2. The order and judgment entered by the District Court on June 10, 1940, is a "final decision" by the court which is subject to review by this Court on an appeal taken therefrom under the provisions of Section 128(a) of the Judicial Code as amended.

3. The District Court erred [R. 160-162]:

(a) In sustaining the appellant's motion to quash and in quashing and annulling its *ex parte* order made on March 5, 1940, for the production of records.

(b) In holding that under the petition and the various affidavits and documentary exhibits submitted at the hearing, appellant failed to make a sufficient showing of probable cause, sometimes called reasonable grounds for suspicion of fraud, to justify his requested re-examination of the appellee corporation's books and records reflecting its transactions with the stockholder taxpayer herein involved.

(c) In permitting appellees to raise in this proceeding (where the tax liability of neither appellee was before the court and the taxpayer is not a party and cannot be bound by any determination herein) any questions as to whether the Commissioner's requested examination of corporate records of Chandis and oral testimony of its assistant secretary respecting certain transactions with its chief stockholder, in order to determine that stockholder's individual income tax liability for the year 1930, is unreasonable, unnecessary, or precluded by the bar of limitation.

(d) In holding that the petition and the *ex parte* order for the production of books and records of Chandis were not limited sufficiently in point of time of transactions and in the number and scope of books and records designated for the requested administrative inquiry and examination.

(e) In holding and finally adjudging that appellant was not entitled to any relief against either appellee in this proceeding.

Summary of Argument.

1. Under plainly worded and applicable statutes the Commissioner, acting by appellant as his authorized field agent, had power and authority to issue this administrative summons and order for production of records under the internal revenue laws and the District Court is expressly given jurisdiction, by appropriate judicial process, to compel compliance with such administrative process. This legislation is to aid the Commissioner in his duty to properly administer the revenue laws.

2. This Court has jurisdiction, under the present appeal, to review the decision of the District Court herein. Technically speaking, that decision was rendered upon a motion to quash an *ex parte* order theretofore granting the relief prayed in the petition. However, it was rendered only after the respective parties, with the tacit approval of the trial court, had virtually submitted the entire controversy to that court for determination upon the merits. Upon the whole record the District Court ruled that appellant was not entitled to any relief against either appellee in this proceeding. The District Court then entered its order and judgment to that substantial effect, although not under that caption or label.

Under the spirit and intent of the new rules now governing civil procedure in the District Courts, that was a "final decision" by the District Court in this action. Hence that decision is subject to review in this Court upon an appeal taken therefrom under the provisions of Section 128(a) of the Judicial Code, as amended.

3. The Commissioner, acting through appellant as his authorized representative, has made a sufficient showing of probable cause, sometimes called reasonable ground for

suspicion of fraud, in connection with the 1930 income tax return of the taxpayer to entitle the Government to the relief prayed in its behalf under the petition.

Such showing of probable cause includes the personal affidavit of the taxpayer and other representations made in her behalf to the Bureau of Internal Revenue which misled the Bureau into treating the asserted interest income transactions now sought to be reinvestigated as having been culminated during the taxable year 1929 until after the statute of limitation had barred the assertion of a deficiency for 1930 upon the basis of that same transaction in the absence of fraud, also her failure to report that interest transaction in her returns for either 1929 or 1930. The opinion below fails to note the taxpayer's own affidavit in this connection.

The Commissioner has met the requirements provided under the internal revenue statutes by making the prescribed requests upon both the taxpayer and the appellee corporation for his local field agents to re-examine the taxpayer's 1930 income tax liability under his direction.

4. The taxpayer is not before the Court and cannot be bound by a determination here. Ample provision is made under the revenue laws for her "day in court" if and whenever the Commissioner of Internal Revenue should assert a deficiency of tax against her under a determination of fraud in connection with her 1930 income tax return. In that event, the taxpayer could appeal to the Board of Tax Appeals and thereby obtain a redetermination of the asserted deficiency prior to its collection. In such contingency she would have a very substantial strategic advantage that was not available to her under previous appeals to the Board in her 1923 and 1929 cases

involving the same asserted interest income under consideration herein. The Commissioner would be under the burden of both alleging and affirmatively proving the asserted fraud as a condition precedent to sustaining any 1930 tax deficiency against the taxpayer. However, such a burden is not imposed upon the Commissioner or his representatives acting in his behalf before that time.

Appellees are not in any position to challenge in this proceeding the propriety of the requested administrative examination of their records or to assert that such examination is unnecessary, unreasonable, in violation of the Federal Constitution or amendments thereto, or useless because of the possible availability to the taxpayer of the plea of limitation.

5. The list of corporate books and records sought to be examined herein looks rather formidable, but the actual number, quantity or volume of such corporate books and records is small enough for same to have been kept for an entire year in one safe belonging to another corporation.

All of those relatively few corporate records should be opened for examination by the Commissioner's agents in connection with his pending reinvestigation of the 1930 tax liability of the chief stockholder of this family corporation. This is especially true in view of the history of the interest-income transactions between them as shown by the record here and dating back almost to the organization of Chandis in 1916. The requested re-examination of all those records is necessary to enable the Commissioner to make ultimately a fair, complete and accurate administrative determination. It would not in fact subject appellees to any unreasonable or oppressive burdens under the showing made here.

ARGUMENT.

I.

The District Court Had Jurisdiction Under the Provisions of Section 3633, Internal Revenue Code, to Grant the Relief Prayed in the Petition.

From the petition and its supporting exhibits, it appears that (a) appellant is the Internal Revenue Agent in Charge at Los Angeles, California, and is the duly authorized field representative of the Commissioner of Internal Revenue to act in his behalf in the matters involved herein [R. 2-3, 8-9]; (b) both of the appellees reside in the City of Los Angeles, California, and within this judicial district [R. 4]; (c) that after Commissioner served the prescribed statutory written notice upon the taxpayer of the necessity to make a re-examination of pertinent records in order to verify the correctness of her 1930 income tax return, the interested parties denied his agents and representatives access to the pertinent and relevant records [R. 9, 25, 34-35]; (d) that the appellant, under the name and direction of the Commissioner issued and served an administrative summons and order upon appellees to submit the designated records for examination and give testimony relating thereto in the matter of the taxpayer's 1930 income tax liability [R. 5, 10] and both appellees refused to comply with that summons [R. 6-7]; (e) that appellant thereafter received the authorization and sanction of both the Commissioner and Attorney General of the United States to commence this proceeding [R. 2-3]; and (f) that appellant filed his petition in the district court of the district where the appellees reside praying for an order requiring the appellees to respond to the administrative summons and order in question [R. 2, 7-8].

In the course of the exercise by the Commissioner of his general power and duty under Section 3901(a)(1), Internal Revenue Code,¹⁰ of “general superintendence of the assessment and collection of all taxes imposed” by the internal revenue laws, he was empowered and it was obviously his duty to direct all administrative examinations necessary to properly administer the revenue laws. Section 1105 of the Revenue Act of 1926, c. 27, 44 Stat. 9, which is the same as Section 3631, Internal Revenue Code, while providing against “unnecessary examinations”, expressly provides that a re-examination may be made when “the Commissioner, after investigation, notifies the taxpayer in writing that an additional inspection is necessary”. That statutory requirement was fully and meticulously met by the Commissioner and the appellant herein, as just pointed out above.

Section 3614, Internal Revenue Code [Appendix, *infra*] provides as follows:

The Commissioner, for the purpose of ascertaining the correctness of any return * * * is authorized, by any officer or employee of the Bureau of Internal Revenue, including the field service, designated by him for that purpose, to examine any books, papers, records, or memoranda bearing upon the matters required to be included in the return, and may require the attendance of the person rendering the return, or of any officer or employee of such person, or * * * of any other person having knowledge in the premises, and may take his testimony with reference to the matter required by law to be included in the return * * *. (Italics supplied.)

¹⁰Footnote 1, *supra*.

That statute is so plain, clear and unambiguous that it covers like a blanket the administrative process sought to be enforced by judicial process herein.

Furthermore, Section 3633, Internal Revenue Code, rather tersely confers jurisdiction upon the district court of the district where such a person resides, if “any person” is summoned under the internal revenue laws “to appear, to testify, or to produce records, papers or other data”, to compel “by appropriate judicial process” such attendance, testimony or production of books, papers or other data.

The authorities construing these statutes clearly sustain the power of the Commissioner, acting through his authorized field agents, to issue administrative process of the nature and for the purpose shown herein, as well as the jurisdiction of the district courts (where the venue is properly laid, as here) to enforce such administrative investigatory process by sentence of contempt when the court orders that the parties respond to the summons and they still refuse to do so.

In *Brownson v. United States*, 32 Fed. (2d) 844 (C. C. A. 8), the court there said (p. 848):

* * * the power granted to the Commissioner
* * * by the statutes above quoted to require the attendance of witnesses and the production of books and papers in matters properly under investigation by him is similar to the power vested by analogous statutes in federal grand juries to perform similar acts, * * * and * * * the statutes involved, granting such power to the Commissioner, should receive a like liberal construction in view of the like important ends sought by the government.

There the superintendent of a local office of the Western Union Telegraph Company was required, under compul-

sion of judicial process, to appear and produce certain records relative to the taxpayer's receipt of certain money by wire. In the case of *In re Lyons*, 32 F. Supp. 92 (E.D. N.Y.) the authority of a revenue intelligence agent to issue and obtain judicial enforcement of a summons and order under Section 3614, Internal Revenue Code, was upheld in order to aid in determining the tax liability of a third party. See also *McCrone v. United States*, 307 U. S. 61, to the same effect. In affirming there a decision of this Court (100 Fed. (2d) 322), the Supreme Court said (p. 64):

* * * Here, the summons served on petitioner required only that he testify in a tax inquiry properly conducted by an agent of the Bureau of Internal Revenue. And the agent's petition to the District Court, to which we may look in determining the nature of the proceeding, invoked judicial assistance solely in obtaining petitioner's testimony. Authority of the court was sought to buttress the procedure for collection of taxes and not in "vindication of the public justice," as in criminal cases.

There the person required by judicial process of the nature involved herein to appear and testify was also a third party and not the taxpayer.

Section 3740, Internal Revenue Code [Appendix, *infra*], provides that civil suits involving collection of internal revenue be commenced with the sanction and authorization of both the Commissioner of Internal Revenue and the Attorney General of the United States. This provision was also complied with. [R. 2-3.]

It is submitted that under the foregoing facts and authorities the jurisdiction of the District Court is so firmly established as to be beyond any serious challenge here.

II.

The Order and Judgment Entered by the District Court on June 10, 1940, Is a "Final Decision" by That Court Which Is Subject to Review on an Appeal Taken Therefrom to the Circuit Court of Appeals for the Ninth Circuit Within the Purview of Section 128(a) of the Judicial Code as Amended.

The only relief prayed in the petition was for an order to be issued by the trial court requiring the appellees to appear before the appellant at his office at the same time designated in his administrative summons and order to produce records and testify. [R. 7, 10-11.] Upon the filing of the petition the trial court issued an *ex parte* order directing appellant to do so. [R. 13-16.] Within the return day of that order as extended [R. 16-18] appellees moved to quash that order. [R. 19-24.] At the hearing upon that motion the parties submitted numerous affidavits and counter-affidavits, respectively asserting and denying the propriety of the relief prayed under the petition upon the merits thereof and supporting their respective positions by voluminous documentary exhibits also submitted at the same time. [R. 7-13, 73-79, 80-135, 141-147, 148-149 for appellant and R. 24-73, 136-140, 150-151, 165-221 and 222-256 for appellees.]

Under those affidavits (which were conflicting as to certain material factors in the case) and under the voluminous documentary exhibits and supporting same, the respective parties did not devote themselves to technical or procedural questions involving the jurisdiction of the trial court over the controversy or involving the manner in which relief had summarily been granted to appellant under the *ex parte* order. On the contrary, both parties,

thereof) *will be offered in evidence at the hearing of said motion, and upon such other evidence as may be offered at said hearing.* (Italics supplied.)

All of the voluminous documentary evidence involving the merits of the whole controversy which was mentioned in that "Notice of Motion to Quash" was submitted by the parties and received and considered by the trial court before rendering his decision affectively denying appellant any and all relief prayed under the complaint.

Obviously it would have been extremely difficult under the old rules of Federal procedure to classify appellees' motion as either a motion to dismiss, a demurrer, a motion for certain interlocutory relief or an answer upon the merits, because it combined the features of all four of these motions or pleadings in one instrument. In fact, under the old rules almost any federal district judge, upon objection by the opposing party, would have stricken that pleading or motion or whatever it might be termed and required appellees to break it up into one, two or three separate or successive motions or pleadings.

However, under the present Federal Rules of Civil Procedure for the District Courts of the United States of America (the material provisions of which are set forth in the Appendix, *infra*) the parties by tacit agreement of counsel and with the approval of court could and did submit the whole controversy to the trial court in this somewhat unusual or hybrid manner in order "to secure the just, speedy and inexpensive determination of every action" within both the spirit and the letter of Rule 1, F. R. C. P., Appendix, *infra*.

Appellees could, under Rule 12(b)(6), [Appendix, *infra*] have moved to dismiss the petition for insufficiency of statement of claim. They might have filed an answer and then moved under Rule 12(c), [Appendix, *infra*] for judgment on the pleadings, or under Rule 56(b) [Appendix, *infra*] for summary judgment in their favor in whole or in part and with or without supporting affidavits. They could also have had their witnesses testify orally and presented their documentary evidence and submitted the case upon the regular trial calendar to the trial court without a jury under Rule 39(b) [Appendix, *infra*]. None of these present rules of federal procedure would have worked as effectively to bring the present case to a speedy and final determination in the trial court as the combined use of all of them has done.

Demurrers were abolished by Rule 7(c), F. R. C. P. [Appendix, *infra*], so we do not have here a situation of the nature which formerly arose when a demurrer to a complaint was sustained and the plaintiff undertook to appeal from that decision before the question of possible amendment to pleadings had been disposed of and formal order dismissing the complaint had been entered. No order comparable to that was necessary here.

When the trial judge entered his order of June 10, 1940, it was obviously upon its face his final determination and judgment that appellant had failed upon the combined pleadings, motions and evidence to make out a case entitling him to any relief in this proceeding and that if the Bureau desired to pursue its administrative inquiry into Mrs. Chandler's 1930 tax liability any further, it would be necessary to file a new suit and start all over.

We submit as a matter of logic, common sense and practical interpretation of both the letter and the spirit of the new rules governing federal district court procedure that this order and judgment was a final decision by the District Court for the purpose of an appeal therefrom to this Court under the provisions of Section 128(a) of the Judicial Code, as amended.

The view just expressed also finds substantial support under the decisions involving cases arising under the old procedure, a few of which authorities are referred to here. As stated in *Ex Parte Norton*, 108 U. S. 237 at page 242—

A decree is final for the purpose of appeal * * * when it terminates the litigation between the parties, and leaves nothing to be done but to enforce by execution what has been determined.

Under the peculiar and novel situation presented here there was not anything for appellees to enforce by execution after winning their lawsuit because they had completely and effectively stymied appellant from furthermore pursuing them in this particular proceeding unless and until the decision of Judge Yankwich should be reversed on appeal.

Bray v. Staples, 180 Fed. 321, 330 (C. C. A. 4th) states that the test for determining finality, and hence appealability, of the decision of a federal trial court—

is not whether the cause remains *in fieri*, in some respects, awaiting further proceedings necessary to en-

title the parties to the full measure of the rights it has been declared they have, but whether the decree * * * ascertains and determines these rights. *If these are ascertained and determined the decree is final.* (Italics supplied.)

City of Eau Claire v. Payson, 107 Fed. 552, 557 (C. C. A. 7).

The Supreme Court has not placed upon the words “final decree”, respecting the right of appeal, a strict and technical sense, but has given them a liberal and reasonable construction.

And again in *Potter v. Beal*, 50 Fed. 860 (C. C. A. 1st) the syllabus states the rule thus:

The question whether a decree is final and appealable is not determined by the name which the court below gives it but is to be decided by the appellate court on a consideration of the issue of what is done by the decree.

In view of the foregoing, we submit that the decision and judgment of the district court from which this appeal is taken is an appealable “final decision” under Section 128(a) of the Judicial Code as amended [Appendix, *infra*] and that this Court has jurisdiction to review that judgment under appellant’s present appeal.

III.

The Commissioner Made a Sufficient Showing of Probable Cause, Sometimes Called Reasonable Grounds for Suspicion of Fraud, to Justify His Requested Reexamination of the Appellee Corporation's Books and Records Reflecting Its Transactions With the Stockholder Taxpayer Herein Involved.

In a proceeding of this character the Government is under no burden either to allege fraud or to prove fraud upon the taxpayer's part. If the Commissioner had all the facts from which he could determine whether there was fraud in connection with the taxpayer's failure to report the large amount of asserted interest income in question, he never would have directed appellant to proceed with the reinvestigation of her 1930 income tax return, nor sanctioned the commencement of this proceeding. Whether there was such fraud is not before the Court. "The Government is merely seeking further⁴ information." *Zimmermann v. Wilson*, 105 F. (2d) 583, 585 (C. C. A. 3d), affirming second decision of the District Court, 25 F. Supp. 75 (E. D. Pa.).

The Commissioner is entitled to enforce obedience to the subpoena directed by his field agent to the appellee family corporation and its assistant secretary in order to obtain further light upon the above interest transactions between the appellees and the taxpayer which "might be fraudulent" upon the taxpayer's part, and which would justify a reexamination into her income producing transactions with the corporation after the statute of limitations had run in the taxpayer's favor in the absence of

such fraud. *Zimmermann v. Wilson* (C. C. A. 3d), *supra*, at p. 586. See also *In re Andrews' Tax Liability*, 18 F. Supp. 804 (Md.); *In re Upham's Income Tax*, 18 F. Supp. 737 (S. D. N. Y.); and *In re Keegan*, 18 F. Supp. 746 (S. D. N. Y.).

The striking analogy of the decision on the second appeal in the *Zimmermann* case to the present proceeding warrants some explanation here of the long litigation preceding that decision. In *Zimmermann v. Wilson*, unreported officially, but found in 16 A. F. T. R. 1070 (E. D. Pa.) (1935), the husband and wife sought to enjoin an examination by revenue agents of brokers' records of certain prior tax years upon the ground that the statute of limitations barred any assessment against the taxpayers for those years. The revenue agents merely moved to dismiss the bill of complaint, without filing an answer and raising any question of fraud; and the District Court dismissed the bill upon the grounds that the records were the property of the brokers and the taxpayer could not be heard to say whether the brokers would submit their records for an administrative examination. Upon appeal by the taxpayers, the Circuit Court of Appeals for the Third Circuit, in an opinion by Circuit Judges Buffington and Davis (who have both retired since then), reversed the decree dismissing the suit under the view that the taxpayers were the real parties in interest in the injunction suit and were entitled to a restraining order to prevent an examination, which, on the face of the bill of complaint, constituted "unreasonable search". *Zimmermann v. Wilson*, 81 F. (2d) 847. Upon remand of the case to the District Court the defendant revenue agents filed an answer raising the question of fraud. Upon the

second trial in the District Court upon bill, answer, and a hearing on the merits, that court dismissed the bill for an injunction and permitted an examination of the brokers' records. In that case the husband and wife had filed separate returns for the years 1929 and 1930, in which each had reported a number of sales of stock and claimed large losses by reason of such sales. Those returns had been audited by revenue agents in the years 1931 and 1932, respectively, and finally approved with some comparatively minor adjustments. After the period of limitation had run, the revenue agents discovered that some of those transactions were between husband and wife, although that fact had not been developed during the timely audit of their respective 1929 and 1930 returns. District Judge Kirkpatrick aptly stated the rule as follows (25 F. Supp. 75, 77):

I have said that fraud is ultimately involved, but that does not mean that it must be proved in this suit. This is not a proceeding to collect a tax, in which fraud must be proved in order to escape the bar of the statute of limitations. What is involved here is the right to make an examination to determine whether or not there is sufficient reason to justify a proceeding to collect the tax.

It seems plain that upon such an issue the Government need not prove fraud or even show a *prima facie* case. * * *

At the second hearing in the District Court, which was upon the merits, it was shown that Zimmermann and his wife had filed separate income tax returns for the years 1929 and 1930, which returns were duly approved by revenue agents who had full access to the books of Drexel

& Company, their stock brokers; that in 1933, and after ordinary assessment had become barred by the two-year limitation under Section 275(a) of the Revenue Act of 1928, [Appendix, *infra*], the agents had discovered upon a check of the books of another broker that certain sales of stock on which large losses had been taken appeared to be between husband and wife. At the time those returns were made there was no requirement that those taxpayers should disclose this fact, and the Zimmermanns had not done so in their returns. When the revenue agents sought further information from Drexel & Company, the latter refused them access to its records under the direction of the Zimmermanns; and the revenue agents were then stopped by a restraining order and preliminary injunction in the bill of complaint brought by the Zimmermanns from enforcing an administrative summons to Drexel similar to the one involved herein. A showing was made in the injunction suit that when the husband made sales of securities on which he had claimed and been allowed large losses, similar purchases in kind and quantity had been made for the wife's account by the husband acting as her agent and dealing through Drexel & Company, as brokers, on the same dates.

The Circuit Court of Appeals, in affirming District Judge Kirkpatrick's decision, recognized that the Bureau's examination must cover a wide field in cases involving transactions between husband and wife to avoid taxes, which were consummated through their stock brokers, and applied to that situation the rule which the District

The showing made by the appellant herein, as the Commissioner's agent, clearly brings this case within the rule announced in the foregoing authorities. Although the District Judge apparently recognized the correct principles applicable to the present situation, he clearly failed to apply these principles under his final disposition of the case.

District Judge Yankwich commented in his opinion herein upon a conflict between affidavits of the revenue agent and of the appellee Downing as to whether Downing had represented to the revenue agent that the transaction involving payment of notes and interest with shares of stock of the appellee corporation now under investigation was consummated during the taxable year 1929 and not in the taxable year 1930. [R. 155.] The District Judge, however, failed to note that the representations attributed by the revenue agent to the appellee Downing conformed completely to the taxpayer's own personal affidavit, which was submitted to the Bureau subsequently on December 17, 1931, in protest against the same revenue agent's report covering her 1929 return and in which she unequivocally represented to the Bureau that the same transaction had taken place "during the calendar year 1929". [R. 87-89.]

When the representatives, acting in the taxpayer's behalf, followed up the taxpayer's sworn protest and personal affidavit just mentioned with a letter to appellant dated March 28, 1932, they likewise referred to the exchange by the taxpayer and her children *on December 31, 1929*, of notes of the appellee corporation payable to those stockholder taxpayers of a face value, together with accrued interest aggregating \$3,515,606.88, being then exchanged for 35,153 shares of stock of the appellee cor-

poration. Such agents challenged the taxability of that exchange upon grounds not material herein, but did not correct the taxpayer's own affidavit in any way as to the transaction having been consummated during 1929. [R. 90-91.]

On April 4, 1932, the former Internal Revenue Agent in Charge at Los Angeles advised the taxpayer by letter that he was forwarding her 1929 return, the agent's report and her protest to the Commissioner at Washington with the recommendation that a deficiency be asserted against her for that year upon the basis, *inter alia*, that she had received interest from Chandis during the calendar year 1929 in the sum of \$661,369.56, as a result of the payment of her notes and accrued interest thereon in stock of Chandis under the transaction above mentioned. [R. 92-94.]

The Commissioner relied upon these representations in the taxpayer's own affidavit and the supplementary protest of her agent, when, on July 1, 1932 he issued a statutory sixty-day deficiency letter to the taxpayer for the year 1929 [R. 67, 69, 71], upon the basis that unreported asserted interest income of \$661,369.56 had been received by the taxpayer during the year 1929 from Chandis as reported by the revenue agent. Similar notices of deficiencies for the year 1929 were likewise sent to the eight children of Mr. and Mrs. Chandler, who were also shareholders in the appellee corporation and situated similar to her in all respects except that they owned smaller numbers of shares of stock than she did. The taxpayer and the eight children all appealed to the Board of Tax Appeals. All nine of those appeals were consolidated and heard together by the Board. [R. 48-50.]

In the meantime, however, the taxpayer waited until August, 1933, or until just before the hearing of these cases before the Board, to give notice to the Commissioner's representative that the deficiencies would be resisted upon the ground that payment of the notes and interest in shares of stock had been consummated in 1930 and not in 1929. [R. 201-202.] Amended petition asserting that change in the position of the taxpayer was filed with the Board on September 25, 1933, and after certain new counsel had come into her case. [R. 201-202.]

The taxpayer had filed her 1930 income tax return on March 16, 1931, but she neither reported nor mentioned the above interest transaction in that return [R. 112-124]. (Neither had she mentioned it in her 1929 return as already brought out.)

In the absence of waiver, the Commissioner was allowed by Section 275(a) of the Revenue Act of 1928 [Appendix, *infra*], two years after that date or until March 16, 1933, to assert a deficiency against the taxpayer for that year and thereby test out the merits of his position and determination that this payment of notes and interest with stock of Chandis constituted a non-taxable exchange under Section 112(b) (5) of the Revenue Act of 1928—a question not material in this proceeding.

When the taxpayer waited until August, 1933, to change her position and attribute the interest-stock transaction to the taxable year 1930, the Commissioner was deprived of that right and put, without fault or neglect upon the part of himself or his agents, under the much more difficult burden of establishing fraud in connection with the taxpayer's 1930 return as a condition precedent to sustaining ultimately any deficiency of tax against her

for that year with respect to the asserted interest income item of \$661,369.56, now under investigation. Section 276(a), Revenue Act of 1928. [Appendix, *infra*.]

In the taxpayer's own affidavit of December 17, 1931, above mentioned, she stated as follows [R. 87-89]:

(2) The year involved is the calendar year 1929

* * *

* * * * *

(4) The facts upon which the taxpayer relies in support of her contentions are as follows:

(a) The taxpayer is a stockholder in the Chandis Securities Company and during the calendar year 1929 and prior thereto was the payee under certain promissory notes signed by the Chandis Securities Company.

(1) *During the calendar year 1929, the Chandis Securities Company in connection with a reorganization, acquired from this taxpayer the notes of the said Company held by the taxpayer.*

(2) At the time the notes were acquired, interest had accrued in the sum of \$70,097.32. The Internal Revenue Agent has erroneously included this sum as income which was not paid to the taxpayer and was not credited to her account or unqualifiedly subject to her demand. It is the contention of the taxpayer that the transaction whereby the taxpayer transferred notes to the Chandis Securities Company for its stock represents an exempt exchange in connection with a reorganization. (Italics supplied.)

The closing balance sheet of Chandis as of December 31, 1929, as put in evidence before the Board, showed that the notes and accrued interest thereon were listed as liabilities of the corporation at the close of that year [R. 193-194]. However, it was stipulated by counsel in that proceeding that Chandis "did not deduct any interest on the notes in question after the year 1929 and that no interest was accrued on the books of the corporation, in respect of the notes, after 1929". [R. 200.]

We have already set forth (1) how and when Chandis was organized, (2) its capital structure, (3) the acquisition by the taxpayer and the children of the first series of promissory notes now in question, (4) the Commissioner's unsuccessful attempt to tax the shareholder payees of those notes with interest added into the face of the renewal notes given December 23, 1923, (5) other phases of the situation leading up to the Commissioner's unsuccessful attempt to tax the asserted interest income as 1929 income of the taxpayer and her children when they accepted shares of stock in settlement and payment of principal and interest accrued to December 31, 1929, upon renewal notes bearing compound interest then held by them, those notes and (6) how Chandis over the years 1918 to 1929, inclusive, deducted from its gross income as a business expense interest upon both series of notes aggregating approximately \$1,500,000, without the Commissioner being successful in his attempts to tax any of that interest to the recipient stockholders for any taxable year to date.

We have also shown that during the period under investigation and inquiry by the Commissioner the appellee Downing acted in the joint capacity of secretary for and custodian of all the records of Chandis involving the above interest transactions with the taxpayer and as the taxpayer's individual representative when Revenue Agent Donnally was making the original field examination of her 1929 return. We put in evidence at the hearing below (1) Mrs. Chandler's own affidavit which was susceptible of only one construction—that the interest-stock transaction in question was consummated in 1929; the affidavit of agent Donnally that Downing upon a certain excuse failed to produce the cancelled notes on stock records to speak for themselves when, in response to a direct inquiry from the agent, Downing had stated the whole transaction was consummated in 1929 and the records would so show if he had then been able to produce them. We have the revenue agent's report to his superior officers about that time of that interview in which the agent reported the interest-stock transaction as a 1929 transaction in his recomputation of the taxpayer's 1929 income. [R. 80, 82-83.] We also have the taxpayer's failure to report or mention the item in her 1930 return in any way [R. 112-124] and her change of position in her 1929 case before the Board after the ordinary statute of limitations barred a 1930 deficiency against the taxpayer.

It was not necessary for the trial judge upon the hearing to resolve the issue of veracity as between agent

Donnally and Downing as to whether Downing actually made the misrepresentations of fact about the interest-stock transaction being consummated in 1929, because the trial court was not required to try the issue of actual fraud herein.

It is submitted that under the pleadings, affidavits and all the evidence of a voluminous documentary nature submitted at the hearing, the District Court erred in failing or refusing to hold that the Commissioner had made a showing of probable cause or reasonable ground for suspicion of fraud that was sufficient to entitle him to proceed with his administrative re-examination into the 1930 income tax liability of Mrs. Chandler.¹²

¹²In view of the manner in which this case went off in the District Court, appellant does not occupy here the position of a litigant seeking to challenge the sufficiency of evidence to support special findings of fact made by a District Judge with full opportunity to see, hear and observe the witnesses when they gave conflicting testimony at a regular hearing upon the merits. We agree that it is not the function of this Court to weigh the evidence in such cases. *Cf. Atlas Beverage Co. v. Minneapolis Brewing Co.*, 113 F. (2d) 672 (C. C. A. 8th); *Schneiderman v. United States*, 119 F. (2d) 500 (C. C. A. 9th). In the present proceeding the District Judge neither saw nor heard a single witness testify. He neither made, nor was required to make, any special findings of fact. He actually ruled, in substance and effect, as he would have done if the case had been submitted to him upon a motion to dismiss or for summary judgment, with supporting and opposing affidavits and exhibits. If that had been the actual procedural situation here, this Court could certainly examine the petition, with its supporting affidavits and exhibits, and the documentary evidence submitted at the hearing, and determine for itself the question of law whether, on the whole record, appellant is entitled to any relief in this proceeding, or whether the District Judge should have set the case down for hearing upon the merits by reason of some genuine and material issue of fact having developed at the hearing upon such a motion. *Cf. Thomas v. Peyser*, 118 F. (2d) 369 (App. D. C.); *Lucking v. Dalano*, 122 F. (2d) 21 App. D. C., and *Wyant v. Crütenden*, 113 F. (2d) 170 (App. D. C.).

Neither the Appellee Corporation nor Its Assistant Secretary Is in a Position to Raise Any Question in This Proceeding as to Whether the Commissioner's Requested Examination of Its Corporate Records of Transactions With Its Chief Stockholder Is Unreasonable, Unnecessary, or Futile Because of the Limitation Against Assessment of a Deficiency, Where the Taxpayer Is Not Before the Court and, Concededly, Cannot Be Bound by Any Determination Herein.

This proceeding is merely one of an ancillary nature. The taxpayer is not a party. There is no occasion for her ever being brought in as a party. No relief is sought against her directly or indirectly. She cannot be bound by any determination herein. The Commissioner cannot now assert a tax deficiency against her for the year 1930 except in case of fraud as permitted under Section 276(a), Internal Revenue Code. [Appendix, *infra*.] If and whenever he should attempt to do so she will have the same right of appeal to the Board of Tax Appeals which she has already exercised successfully with respect to the taxable years 1920-1923 and 1929.¹³ In any such event the Commissioner will have the burden of affirmatively establishing fraud in order to test out on the merits his position that the payment of interest in stock of Chandis constituted the receipt of income by the taxpayer. Sec-

¹³*Chandler v. Commissioner*, 16 B. T. A. 1248, 1249, *supra*, covers 1920-1923, inclusive, and *Chandler v. Commissioner*, 32 B. T. A. 720, affirmed as *Commissioner v. Chandler*, 89 F. (2d) 332 (C. C. A. 9th), *supra*, cover the year 1929.

tion 1112, Internal Revenue Code, expressly imposes such a burden upon the Commissioner by providing as follows:

In any proceeding involving the issue whether the petitioner has been guilty of fraud with intent to evade tax, the burden of proof in respect of such issue shall be upon the Commissioner. (U. S. C., Supp. V, Title 26, Sec. 1112.)

There is no basis for meritorious objection to the enforcement of the administrative process now in question upon the ground of its being unreasonable, unnecessary, untimely or oppressive, so far as the taxpayer is concerned, where no burden can be imposed directly or indirectly upon her through its enforcement. The appellee third parties are not in any position to raise any such question in her behalf in a proceeding of this kind. *Zimmermann v. Wilson*, 105 F. (2d) 583 (C. C. A. 3d), *supra*; *In re Upham's Income Tax*, 18 F. Supp. 737 (S. D. N. Y.), *supra*; *In re Keegan*, 18 F. Supp. 746 (S. D. N. Y.), *supra*.

The case of *Caplis v. Helvering*, 4 F. Supp. 181 (E. D. N. Y.), was a suit by a third party who had acted as attorney for the taxpayer prior to the latter's death to restrain a field officer of the Bureau of Internal Revenue from conducting an administrative investigation into the tax liability of the decedent's estate. Caplis there asserted unsuccessfully all the constitutional and other defenses, including the bar of statute of limitation, as have been raised by appellees while occupying the position of

third parties here. With particular reference to the attempt by a party other than the taxpayer to inject the limitation question in that case the court there, in denying the injunction, very aptly said (p. 183):

So far as insistence is had on the statute of limitation as a bar, it may be said that it does not lie in the mouth of plaintiff to assert that the statute of limitations has run against the Phillips estate. Conceivably, such a defense might be asserted by the representatives of that estate in an action brought by the United States government against them.

The same rule is applied in suits by the United States against banks or other third parties holding funds or other property of a delinquent taxpayer and refusing to turn over such funds or property when served with a warrant of distraint. The third party is not permitted in any such proceeding to plead that collection of the tax is barred by limitation or to assert any other defense to show the tax is not due, since ample provision is made under the revenue laws in which the taxpayer may have his "day in court" under a claim and direct suit for refund of taxes illegally collected if he wants to test out the question of collection after the bar of limitation. (*Cf. United States v. American Exchange Irving Trust Co.*, 43 F. (2d) 829 (S. D. N. Y.); *United States v. First Capital Nat. Bank*, 89 F. (2d) 116 (C. C. A. 8th).)

V.

The Commissioner Should Not Be Limited in His Examination Either as to Particular Books and Records of the Appellee Corporation or as to the Time of Transactions Leading Up to or Forming Part of Those Between the Taxpayer and the Corporation Which Are Now in Question by Reason of Such Transactions Having Occurred Prior to Any Fixed, Arbitrary Date.

As already pointed out, Chandis was organized in 1916 when Harry Chandler, husband of the taxpayer, paid for its original issue of 500 shares of stock of aggregate par value of \$500,000 by transferring various investment properties and securities to Chandis in payment for its stock and causing the stock to be issued in proportions of 40% to his wife (the taxpayer here), 56% in equal proportions to his eight children, and the remaining 4% to himself. Shortly after its organization he began transferring other properties to Chandis, taking its interest-bearing notes in exchange for such properties, and transferring the notes to his wife and children in proportion to their stockholdings. [R. 50-51.]

On or about December 31, 1923, Chandis charged on its books as a corporate liability and expense all of the interest which had accrued upon this first series of notes held by Mrs. Chandler and the children over the immediately preceding six years or as far back as the year 1918, and credited that simple interest to the accounts of those respective individuals. [R. 59-60.] Chandis gave renewal notes dated December 31, 1923, to the respective noteholders with the interest thus accrued upon the old notes to that date added into the face of the new notes maturing December 31, 1929 [R. 44-45, 51-52],

which new notes bore 5% annual interest, compounded annually. [R. 53.] Chandis has accrued the compound interest annually upon its books over the years 1924-1929, inclusive, and taken that aggregate interest deduction of \$875,008.67 from its income for the years 1924-1929, inclusive. [R. 51-52, 55.] The interest which accrued against Chandis prior to and including December 31, 1923, amounted to the aggregate sum of \$702,049.61 [R. 51], when those notes were surrendered on that date and new ones given maturing December 31, 1928. All of that interest was set up on the books of Chandis on or about December 31, 1923, as an accrued expense and liability and correspondingly credited to the accounts of the taxpayer and the children as the basis for the renewal notes then given. [R. 60, 51-52.] Apparently, that entire accrued interest item of \$702,049.61 was deducted from income of Chandis in its return for the calendar year 1923, without the propriety of such deduction being challenged by the Commissioner.¹⁴

The Commissioner has made two unsuccessful attempts to tax as interest income to the shareholders of Chandis the amounts corresponding to interest thus deducted by the corporation over that long period of not less than the aggregate sum of \$1,577,058.67 (\$702,049.61 accrued to December 31, 1923, on the first series of notes [R. 51], plus \$875,008.67 accrued thereafter through December 31,

¹⁴In the income tax return filed by Chandis for the calendar year 1923, it claimed a deduction from gross income for interest expense in the aggregate sum of \$738,577.33, and reported a net loss for that year of \$618,270.74, and the Commissioner upon audit of that return never assessed any deficiency against the appellee corporation for that year. [R. 125.] From the balance sheet made schedule K to that return, it further appears that the appellee corporation's liability on account of notes payable was \$2,162,074.01 on January 1, 1923, and that this liability had increased to \$2,825,843.28 on December 31, 1923. [R. 128.]

1929, upon the second series of notes. [R. 52]). The taxpayer's share of that aggregate interest, is conceded in her amended petition before the Board of Tax Appeals in her 1929 case to have been \$661,369.56. [R. 168.] The second series of notes, maturing December 31, 1929, in the aggregate principal of \$2,640,598.21, plus compound interest accrued thereon to December 31, 1929 of \$875,008.67 [R. 52], was found by the Board of Tax Appeals, with the affirmance of this Court, to have been surrendered and canceled during the year 1930, in consideration of the issuance of additional shares of stock of Chandis of the aggregate par value of \$3,515,600. [R. 56.]

During the year 1929, the appellee Downing was secretary of the appellee corporation, and his particular function was taking care of its financial records. [R. 201.] When the taxpayer's individual 1929 return was under investigation by the Bureau, he also acted as her individual tax agent or representative. [R. 74, 136.] He so admitted in the 1929 case before the Board. The Board found that all of the promissory notes payable to the taxpayer and the eight children were in his custody throughout the entire taxable year 1929. [R. 55, 197.] He also admitted that during the entire year 1929, he kept all the notes, together with all the books and records of Chandis relating to its financial transactions since its organization in one safe; that the safe belonged to the Times Mirror Company; and that his office and that safe were in an office of the Times Mirror Company, which was assigned by that company to Chandis for the transaction of the latter's business. [R. 197.]

The list of records of Chandis required to reflect the complete history of the interest transactions now under

investigation would appear to be rather formidable. [R. 5, 19-20.] However, the actual volume of all such records sought to be investigated herein is comparatively small in kind and quantity. Chandis is not an operating concern. It is only a family holding or investment corporation. All of the records reflecting its financial transactions were thus kept in one safe during the entire year 1929, and are probably kept at present in a receptacle no larger than that. The contention urged with some success by appellees in the court below that an examination of any or all of these records would impose a hardship upon the appellees is clearly without merit.

The Supreme Court in recent years has shown a rather decided tendency to uphold the Commissioner when he scrutinizes closely transactions between an individual stockholder and a controlled or family corporation for the purpose of determining whether such transactions are what they purport to be on the surface or had a different substance and hence different tax consequences. *Cf. Gregory v. Helvering*, 293 U. S. 465; *Higgins v. Smith*, 308 U. S. 473, and *Griffiths v. Commissioner*, 308 U. S. 355. Chandis has already had the benefit of deductions from its own gross income with respect to the interest transactions between itself and its principal stockholder now under investigation. Surely the Commissioner is now entitled to the aid of the courts in this proceeding where his sole purpose is to enable him to ascertain and determine the real substance and tax consequences of this same long series of interest transactions and also to determine whether the taxpayer has been guilty of fraud in connection with her failure to report taxable income for the year 1930.

The Commissioner should have the opportunity to check fully into the matter of how, when and at what cost the various properties held by the appellee corporation at the end of its taxable year 1929 were acquired, as a part of the requested administrative re-examination of records. This is needed in order to determine the value of the stock which the taxpayer accepted in payment of interest. The Commissioner should not be limited with respect to that phase of the case to the list of securities or properties appearing in the balance sheet of Chandis on December 31, 1929.

Furthermore, it is not practicable to draw an arbitrary line for the purpose of limiting the Commissioner's investigation to transactions occurring after a particular date somewhere between 1916 and 1930, or to particular corporate books and records without hampering and restricting the Commissioner in the investigation now sought to be made by him.

In the light of the whole picture presented by the record, the Commissioner should be entitled to examine into all of the corporate books and records described in the petition, and an order and direction by the Court to that effect will not impose any arbitrary, oppressive or unreasonable burden upon either of the appellees.

Conclusion.

(a) The District Court had jurisdiction under the provisions of Section 3633, Internal Revenue Code, to grant the relief herein prayed.

(b) The order and judgment entered by the District Court on June 10, 1940, is a "final decision" by that court which is subject to review here upon an appeal

taken therefrom under the provisions of Section 128(a) of the Judicial Code as amended.

(c) The final decision of the District Court should be versed and set aside, and its earlier order for the production and examination of records should be reinstated and made final.

(d) In any event, the final decision of the District Court should be modified so that the Commissioner will not be limited either as to the particular books and records of the appellee corporation subject to production and examination or as to the time of transactions leading up to or forming part of those between the taxpayer and the appellee corporation subject to investigation.

Respectfully submitted,

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March 16, 1942.

APPENDIX.

Internal Revenue Code:

SEC. 3614. EXAMINATION OF BOOKS AND WITNESSES.

(a) *To Determine Liability of the Taxpayer.*—The Commissioner, for the purpose of ascertaining the correctness of any return or for the purpose of making a return where none has been made, is authorized, by any officer or employee of the Bureau of Internal Revenue, including the field service, designated by him for that purpose, to examine any books, papers, records, or memoranda bearing upon the matters required to be included in the return, and may require the attendance of the person rendering the return or of any officer or employee of such person, or the attendance of any other person having knowledge in the premises, and may take his testimony with reference to the matter required by law to be included in such return, with power to administer oaths to such person or persons.

* * * * *

(U. S. C., Supp. V, Title 26, Sec. 3614.)

SEC. 3631. RESTRICTIONS ON EXAMINATION OF TAXPAYERS.

No taxpayer shall be subjected to unnecessary examinations or investigations, and only one inspection of a taxpayer's books of account shall be made for each taxable year unless the taxpayer requests otherwise or unless the Commissioner, after investigation,

notifies the taxpayer in writing that an additional inspection is necessary.

(U. S. C., Supp. V, Title 26, Sec. 3631.)

SEC. 3633. JURISDICTION OF DISTRICT COURTS.

(a) *To Enforce Summons.*—If any person is summoned under the internal revenue laws to appear, to testify, or to produce books, papers, or other data, the district court of the United States for the district in which such person resides shall have jurisdiction by appropriate process to compel such attendance, testimony, or production of books, papers, or other data.

* * * * *

(U. S. C., Supp. V, Title 26, Sec. 3633.)

SEC. 3740. No suit for the recovery of taxes, or of any fine, penalty, or forfeiture, shall be commenced unless the Commissioner authorizes or sanctions the proceedings and the Attorney General directs that the suit be commenced.

(U. S. C., Supp. V, Title 26, Sec. 3740.)

Judicial Code, as Amended:

128(a). The circuit courts of appeal shall have appellate jurisdiction to review by appeal final decisions—

First. In the district courts, in all cases save where a direct review of the decision may be had in the Supreme Court under section 238. * * *

(U. S. C., Title 28, Sec. 225.)

Revenue Act of 1928, c. 852, 45 Stat. 791:

SEC. 275. PERIOD OF LIMITATION UPON ASSESSMENT AND COLLECTION.

Except as provided in section 276—

(a) *General rule.*—The amount of income taxes imposed by this title shall be assessed within two years after the return was filed, and no proceeding in court without assessment for the collection of such taxes shall be begun after the expiration of such period.

* * * * *

SEC. 276. Same—EXCEPTIONS.

(a) *False return or no return.*—In the case of a false or fraudulent return with intent to evade tax or of a failure to file a return the tax may be assessed, or a proceeding in court for the collection of such tax may be begun without assessment, at any time.

* * * * *

Rules of Civil Procedure for the District Courts of the United States.

Rule 1. * * *. These rules govern the procedure in the district courts of the United States in all suits of a civil nature whether cognizable as cases at law or in equity * * *. They shall be construed to secure the jus, speedy and inexpensive determination of every action.

Rule 7. * * *.

(c) * * *. Demurrers, pleas, and exceptions for insufficiency of a pleading shall not be used.

Rule 10. * * *.

(c) * * *. Statements in a pleading may be adopted by reference in a different part of the same pleading or in another pleading or in any motion. A copy of any written instrument which is an exhibit to a pleading is a part thereof for all purposes.

Rule 12. Defenses and Objections. * * *.

(b) HOW PRESENTED. Every defense * * * to a claim for relief in any pleading, whether a claim * * * shall be asserted in the responsive pleading thereto * * * except that the following defenses may * * * be made by motion: * * * (6) failure to state a claim upon which relief can be granted. * * * No defense or objection is waived by being joined with one or more defenses or objections in a responsive pleading or motion. * * *.

(c) MOTION FOR JUDGMENT ON THE PLEADINGS. After the pleadings are closed * * * any party may move for judgment on the pleadings.

Rule 39. Trial by Jury or by the Court. * * *.

(b) BY THE COURT: Issues not demanded for trial by jury * * * shall be tried by the court * * *.

Rule 56. Summary Judgment. * * *.

(b) FOR DEFENDING PARTY. A party against whom a claim * * * is asserted * * * may * * * move with or without supporting affidavits for a summary judgment in his favor as to all or any part thereof.

³
United States Circuit Court of Appeals
FOR THE NINTH CIRCUIT

GEORGE D. MARTIN, as Internal Revenue Agent in Charge
for the Sixth United States Internal Revenue Collection
District of California,

Appellant.

vs.

CHANDIS SECURITIES COMPANY and H. E. DOWNING,
as Assistant Secretary of Chandis Securities Company,

Appellees.

Upon Appeal from the District Court of the United States for the
Southern District of California, Central Division.

APPELLEES' CUMULATIVE BRIEF.

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APR 15 1942



TOPICAL INDEX.

	PAGE
PREFATORY STATEMENT	1
STATEMENT OF THE PLEADINGS AND FACTS DISCLOSING THE BASIS OF THE CONTENTED JURISDICTIONS.....	2
Jurisdiction of the District Court.....	2
Jurisdiction of This Court.....	2
STATEMENT OF THE CASE.....	3
Summary of Proceedings in the District Court.....	3
Admitted Historical Facts, 1916 to 1923.....	4
Admitted Historical Facts, 1924 to Date.....	5
Appellant's Concession	8
ARGUMENT	9
Summary of the Argument.....	9
Point I.	
Jurisdiction of the District Court to Issue the "Order for Production of Records" of March 5, 1940, and of This Court to Entertain the Pending Appeal, Is Doubtful.....	10
District Court Order for Production of Records.....	10
Jurisdiction of This Court.....	11
Point II.	
There Has Been No Sufficient Showing of Reasonable Ground for Suspicion of Fraud or Probable Cause for Sus- picion Thereof to Justify a Reexamination of Appellee Chandis' Records	16
Analysis of Appellant's Alleged Grounds for Suspicion of Fraud	16
Petition for production of records and affidavits in sup- port thereof	16
Amount of interest accrued on Mrs. Chandler's notes long known to Commissioner.....	19

The Commissioner has stipulated to the value of the stock received in exchange for the notes.....	20
Mrs. Chandler believed, in good faith, that her acquisition of stock did not result in income.....	21
District Court held no showing of probable cause of suspicion of fraud.....	23

Point III.

The Subpoena Is Unreasonable and Oppressive; It Is Unlimited in Scope and Lacking in Particularity and It Embraces an Excessive Period of Time; if Enforced It Would Constitute an Unreasonable Search and Seizure of Appellee Chandis' Records in Violation of the Fourth Amendment to the Constitution of the United States and an Abuse of the Process of the Court.....	35
---	----

Point IV.

Chandis, the Possessor and Owner of the Documents Subpoenaed, Is Entitled to Challenge the Validity of the Subpoena Duces Tecum.....	42
Appellant's authorities analyzed and distinguished.....	42
The investigation here sought, although ostensibly one concerning Mrs. Chandler, is actually an investigation in connection with the tax returns of Chandis for the years 1916 to 1930.....	44
Unnecessary examinations are forbidden.....	48
Appellant has failed to show that the records demanded have any bearing upon matters required to be included in Mrs. Chandler's return.....	49
CONCLUSION	51
APPENDIX	53
Summary of Supreme Court Decisions Establishing Criteria for Determining Reasonableness of a Subpoena Duces Tecum	53

TABLE OF AUTHORITIES CITED.

CASES.	PAGE
Andrews' Tax Liability, Matter of, 18 F. Supp. 804.....	8, 24
Atlantic Fruit Co. v. Red Cross Line, 5 F. (2d) 218.....	30
Boyd v. United States, 116 U. S. 616.....	51
Bray v. Staples, 180 F. 321.....	12
Brooklyn Pawnbrokers, Inc., In re, 39 F. Supp. 304.....	8, 25
Brown v. United States, 276 U. S. 134.....	57
Brownson v. United States, 32 F. (2d) 844.....	15
Burnham v. Commissioner, 33 B.T.A. 147.....	22, 50
Caplis v. Helvering, 4 F. Supp. 181.....	43
Chandler v. Commissioner, 16 B.T.A. 1248.....	5
Chandler v. Commissioner, 32 B.T.A. 720.....	6
City of Eau Claire v. Payson, 107 F. 552.....	12
Cobbledick v. United States, 309 U. S. 323.....	13, 14
Commissioner v. Chandler, 89 F. (2d) 332.....	6
Consolidated Rendering Co. v. Vermont, 207 U. S. 541.....	36, 54
Cudahy Packing Co. v. United States, 15 F. (2d) 133.....	36
Dumbra v. United States, 268 U. S. 435.....	26
Farmers' & Mechanics' National Bank v. United States, 11 F. (2d) 348	8, 15
Federal Trade Commission v. American Tobacco Co., 264 U. S. 298	41, 56
Federal Trade Commission v. Smith, 34 F. (2d) 323.....	36
Go-Bart Co. v. United States, 282 U. S. 344.....	35, 36
Gregory v. Helvering, 293 U. S. 465.....	40
Griffiths v. Commissioner, 308 U. S. 355.....	40
Hale v. Henkel, 201 U. S. 43.....	53

No. 9735

United States Circuit Court of Appeals

FOR THE NINTH CIRCUIT

GEORGE D. MARTIN, as Internal Revenue Agent in Charge
for the Sixth United States Internal Revenue Collection
District of California,

Appellant.

vs.

CHANDIS SECURITIES COMPANY and H. E. DOWNING,
as Assistant Secretary of Chandis Securities Company,

Appellees.

APPELLEES' CUMULATIVE BRIEF.

Prefatory Statement.

At the oral argument on February 24, 1942, the court on its own motion ordered the "Brief for the Appellant" stricken from the files and instructed appellant to file a further brief. There is now on file a "Second Brief for Appellant." On March 28, 1942, Judge Denman signed an order permitting appellees to file a new brief, which we have designated "Appellees' Cumulative Brief." This brief is in response to the Second Brief for Appellant. It embraces all of the matters considered in Appellees' Brief and in addition certain matters raised for the first time in the Second Brief for Appellant. It entirely supersedes Appellees' Brief.

Statement of the Pleadings and Facts Disclosing the Basis of the Contended Jurisdictions.

Jurisdiction of the District Court.

The pleadings and facts disclosing the basis upon which appellant contends the District Court had jurisdiction are stated in Second Brief for Appellant, pages 2-4. The statute relied on by appellant is Internal Revenue Code Sec. 3633.¹

Jurisdiction of the District Court to issue the Order for Production of Records [R. 13] is considered (*post*, pp. 10 and 11.)

Jurisdiction of This Court.

The pleadings and facts disclosing the basis upon which appellant contends this court has jurisdiction upon appeal to review the order granting the motion to quash the Order for Production of Records [R. 151] are stated in Second Brief for Appellant, pages 5-6. Jurisdiction is invoked under Sec. 128(a) of the *Judicial Code*.²

Jurisdiction of this court is considered (*post*, pp. 11 to 15).

¹Sec. 3633: "If any person is summoned under the internal revenue laws to appear, to testify, or to produce books, papers, or other data, the district court of the United States for the district in which such person resides shall have jurisdiction by appropriate process to compel such attendance, testimony, or production of books, papers, or other data."

²Sec. 128(a): "The Circuit Courts of Appeal shall have appellate jurisdiction to review by appeal final decisions—First. In the District Courts, in all cases save where a direct review of the decision may be had in the Supreme Court under Sec. 345 of this title." (28 U.S.C. Sec. 225.)

Statement of the Case.

On Monday, March 16, 1931, Marian Otis Chandler (hereafter called "Mrs Chandler") filed her federal income tax return for the calendar year 1930 [R. 112]. Nearly nine years later (November 10, 1939) appellant served upon appellee Chandis Securities Company (hereafter called "Chandis") a letter from the Commissioner of Internal Revenue advising that a reinvestigation of its records for the years 1916 to 1930 was deemed necessary in order to verify its income tax returns for those fifteen years [R. 25, 37-38]. On November 28, 1939, Chandis by letter advised the Commissioner it would not permit the examination [R. 38]. On November 30, 1939, appellant issued and served two administrative summonses on Chandis—one pertaining to Mrs. Chandler's 1930 income tax [R. 10], the other to Chandis' income tax liability for the years 1916 to 1930 [R. 40]. Each summons required the production of substantially the same documents, namely, *all records of Chandis for the years 1916 to 1930* [R. 10, 40]. Appellees did not comply with either summons.

Summary of Proceedings in the District Court.

Thereupon appellant petitioned the District Court for an order requiring the production of said records, assigning as his reason the desire to reinvestigate Mrs. Chandler's 1930 return [R. 2]. Appellant has never petitioned the court to compel production of these records in connection with his investigation of the returns of Chandis for the years 1916 to 1930. *But he is seeking, while ostensibly investigating Mrs. Chandler's return for one year, 1930, to examine Chandis' records for fifteen years!*

District Judge Yankwich on March 5, 1940, made an *ex parte* order, as prayed for by appellant [R. 13-16]. Thereafter appellees made timely motion to quash the order [R. 19], and on June 10, 1940, Judge Yankwich granted appellees' motion

“* * * without prejudice, however, to a new application upon a new petition and a proper showing limited in point of time and ‘to matters required to be included in the return’ of Marian Otis Chandler, with special reference to the particular transaction which is under investigation.”

[R. 151-152.]

The revenue authorities never availed themselves of the right to file a new application, but instead elected to file the instant appeal.

**Admitted Historical Facts,
1916 to 1923.**

Chandis was created by Mrs. Chandler's husband, Harry Chandler, in 1916. Forty per cent of its capital stock (200 shares) was issued to Mrs. Chandler and fifty-six per cent (280 shares), in equal proportions, to her eight children [R. 51]. Soon thereafter Mr. Chandler transferred assets to Chandis and received from it interest-bearing (5%) promissory notes which he assigned to Mrs. Chandler and the children in approximately the same proportion as their stockholdings [R. 58]. Interest accrued on December 31, 1923, totaled \$702,049.61, of which amount \$294,950.76 was due Mrs. Chandler [R. 44]. On December 31, 1923, Chandis issued new notes (augmented by the accrued interest) to Mrs. Chandler and the children [R. 45]. The Commissioner assessed

deficiencies against Mrs. Chandler for the years 1920 to 1923, inclusive, his theory being that she had constructively received interest income. On appeal to the Board of Tax Appeals, the deficiencies were disallowed [R. 58].³

These facts have long been known to the Commissioner. In 1924 he made an exhaustive analysis of Chandis' records for the years 1919 to 1923, inclusive [R. 32]. He has been intimately familiar with the accrual of interest by Chandis from the date of execution of the notes to December 31, 1923, when the new notes, with accrued interest, were executed [R. 58-60].

**Admitted Historical Facts,
1924 to Date.**

Chandis was unable to pay any interest on the new notes, although it accrued the same on its books, as permitted by law, and deducted the same in determining its net taxable income. The amount accrued between January 1, 1924, and December 31, 1929, aggregated \$875,008.67, of which \$366,418.80 was owed Mrs. Chandler [R. 45]. During the latter part of 1929, pursuant to corporate proceedings duly taken and by virtue of a permit issued by the California Corporation Commissioner, Chandis increased its capitalization and was authorized to issue new stock, at a ratio of ten new shares for one old share, and to cancel its indebtedness to the note holders by issuing additional stock at the rate of one share for each \$100.00 of indebtedness [R. 45-47]. The Corporation Commissioner's permit required that cancellation of the notes and issuance of the stock be done

³*Chandler v. Commissioner*, 16 B.T.A. 1248 (promulgated June, 1929).

concurrently, and that new stock not be issued until the notes were cancelled [R. 56-57]. After the exchange was completed, Mrs. Chandler owned 16,721 shares, having received 2,000 shares in exchange for her 200 old shares and 14,721 new shares in cancellation of Chandis' indebtedness to her [R. 47]. As a result of this transaction, the Commissioner in July, 1932, levied an additional assessment against Mrs. Chandler on the theory that all accrued interest (from the inception of the notes in 1916), as represented by the new stock, constituted interest income for the year 1929, in the amount of \$661,369.56 [R. 67-72]. Thereupon Mrs. Chandler appealed to the Board of Tax Appeals [R. 165].

The foregoing facts were stipulated to be true by the Commissioner at the time of the hearing of the appeal [R. 28, 43-47]. The Board of Tax Appeals found that the notes were cancelled January 2, 1930, that the new stock was issued as of that date, and that

"The books of the company contain appropriate entries to show that the transactions were consummated in 1930."

[R. 55.]

Because of this finding, the deficiencies for the year 1929 were disallowed, the Board declaring that if income had been received, it was not until 1930⁴ [R. 57]. This court affirmed the decision of the Board.⁵

In 1929 the Commissioner made an exhaustive analysis of Chandis' records for the years 1924 to 1927, inclusive

⁴*Chandler, et al. v. Commissioner*, 32 B.T.A. 720 (promulgated June, 1935).

⁵*Commissioner v. Chandler*, 89 F. (2d) 332 (decided April, 1937).

[R. 32], and thereafter made final determinations of deficiencies for these years, from which Mrs. Chandler appealed to the Board of Tax Appeals [R. 139]; subsequently he made an examination for the year 1928 [R. 32]. In 1932 the Board, pursuant to written stipulations executed by the Commissioner and Mrs. Chandler, entered orders determining no deficiencies for each of the years 1924 to 1927 [R. 140]. At about the same time the Commissioner withdrew a proposed assessment for the year 1928 [R. 139-140]. The Revenue Agent in charge advised Chandis that its returns for the years 1929 and 1930 would be recommended for acceptance, and at no time has any notice of action contrary to this recommendation been given [R. 32-33].

At the hearing before the Board of Tax Appeals involving Mrs. Chandler's and the children's deficiencies for 1929, there were introduced in evidence the stock certificate book of Chandis, the notes held by Mrs. Chandler and the children which they exchanged for stock, photostatic copies of the new stock certificates and original book entries of Chandis relating to the issuance of the stock [R. 30, 222-237]. Copies at that time were furnished the Commissioner's representative [R. 30]. Pursuant to stipulation there were introduced two copies of the corporate minutes relating to the exchange of notes for stock [R. 29]. There was also introduced the balance sheet of Chandis dated December 31, 1929, which showed the notes still outstanding and that the capital stock increase had not as yet been effected [R. 229]. This

balance sheet was a part of Chandis' 1929 income tax return filed on March 15, 1930, and it, too, reflected the notes as still outstanding and the original capital stock liability as of December 31, 1929 [R. 240-241].

Additional persuasive evidence illustrating the detailed knowledge that the Commissioner has respecting accrual of interest by Chandis on these notes and the exchange of new stock for cancellation of the notes will be found in admissions in the Commissioner's answer to Mrs. Chandler's amended petition before the Board of Tax Appeals [R. 165-176]. The Commissioner expressly admitted that on Mrs. Chandler's notes interest had accrued to December 31, 1929, in the amount of \$661,369.56 [R. 174].

The undisputed testimony of appellee Downing before the Board of Tax Appeals clearly and fully recites the manner in which the exchange of stock for notes was accomplished [R. 176-195].

Appellant's Concession.

Appellant concedes that the statute of limitations⁶ precludes him from sustaining a deficiency against Mrs. Chandler for income received in 1930, in the absence of proof of fraud (2d Br. 48), and that in order to be entitled to make the investigation which he is here attempting, he must establish reasonable grounds for a suspicion that fraud existed (2d Br. 54). The authorities so hold.⁷

⁶Sec. 275(a) of the *Revenue Act of 1928*: "The amount of income taxes imposed by this title shall be assessed within two years after the return was filed * * *."

⁷*Farmers' & Mechanics' National Bank v. United States*, 11 F. (2d) 348 (C.C.A. 3); *In re Andrews' Tax Liability*, 18 F. Supp. 804 (D.C. Md.); *In re Brooklyn Pawnbrokers, Inc.*, 39 F. Supp. 304 (D.C.N.Y.); *Matter of Morris & Cummings Dredging Co.*, 9 A.F.T.R. 1665 (D.C.N.Y.).

ARGUMENT.

Summary of the Argument.

POINT I. JURISDICTION OF THE DISTRICT COURT TO ISSUE THE "ORDER FOR PRODUCTION OF RECORDS" OF MARCH 5, 1940, AND OF THIS COURT TO ENTERTAIN THE PENDING APPEAL, IS DOUBTFUL.

POINT II. THERE HAS BEEN NO SUFFICIENT SHOWING OF REASONABLE GROUND FOR SUSPICION OF FRAUD OR PROBABLE CAUSE FOR SUSPICION THEREOF TO JUSTIFY A REEXAMINATION OF APPELLEE CHANDIS' RECORDS.

POINT III. THE SUBPOENA IS UNREASONABLE AND OPPRESSIVE; IT IS UNLIMITED IN SCOPE AND LACKING IN PARTICULARITY AND IT EMBRACES AN EXCESSIVE PERIOD OF TIME; IF ENFORCED IT WOULD CONSTITUTE AN UNREASONABLE SEARCH AND SEIZURE OF APPELLEE CHANDIS' RECORDS IN VIOLATION OF THE FOURTH AMENDMENT TO THE CONSTITUTION OF THE UNITED STATES AND AN ABUSE OF THE PROCESS OF THE COURT.

POINT IV. CHANDIS, THE POSSESSOR AND OWNER OF THE DOCUMENTS SUBPOENAED, IS ENTITLED TO CHALLENGE THE VALIDITY OF THE SUBPOENA DUCES TECUM.

POINT I.

Jurisdiction of the District Court to Issue the "Order for Production of Records" of March 5, 1940, and of This Court to Entertain the Pending Appeal, Is Doubtful.

District Court Order for
Production of Records [R. 13].

Jurisdiction of the District Court is considered by the Second Brief for Appellant (pp. 2-4, 29-32). Reliance is had upon *Internal Revenue Code* Secs. 3614 and 3740.

The language of Sec. 3633 (*ante*, p. 2, footnote 1) appears to be sufficiently definite to authorize the District Court in issuing process to compel attendance and production of documents if the jurisdictional facts specified in Sec. 3614 are first made to appear. Certainly the appearance of jurisdictional facts is not conspicuous.

Sec. 3614(a) provides:

"The Commissioner, for the purpose of ascertaining the correctness of any return * * *, is authorized, * * *, to examine any books, * * * and may require the attendance of the person rendering the return * * *, or the attendance of any other person having knowledge in the premises, and may take his testimony with reference to the matter *required by law to be included in such return*, * * *."

Internal Revenue Code, Sec. 3614(a).

In the Second Brief for Appellant (pp. 2-4), under the title "Jurisdiction of District Court", there is no statement that in the return of Marian Otis Chandler for the year 1930 any "matter required by law to be included in

such return” was omitted. Elsewhere in appellant’s Second Brief we do not observe statement to that effect.

If the record discloses that “the matter required by law to be included in such return” was omitted therefrom, it would appear that the District Court had jurisdiction under Sec. 3633 to issue the Order of March 5, 1940 [R. 13]. We find in the Second Brief for Appellant no specific identification of the “matter required by law to be included in such return” *which was omitted* therefrom.

Appellant’s failure to mention the item is difficult of understanding in view of the prominence given the problem in the Order of the District Court, viz:

“The order is quashed and annulled without prejudice, however, to a new application upon a new petition and a proper showing limited in point of time and ‘to *matters required to be included in the return*’ of Marian Otis Chandler, with special reference to the particular transaction which is under investigation.”

[R. 157.]

Jurisdiction of This Court.

Second Brief for Appellant (pp. 5 and 6) is given over to a consideration of the jurisdiction of this court. The only authority cited (bottom p. 6) is Sec. 128(a) (*ante*, p. 2, footnote 2) of the *Judicial Code*. The language of the code provision is simple. Its interpretation, when applied to orders of court, is occasionally difficult. If the Minute Order of the District Court of June 10, 1940

[R. 151], quashing the Order for Production of Records of March 5, 1940 [R. 13], is a “final decision” within the meaning of Sec. 128(a) of the *Judicial Code*, this court would appear to have appellate jurisdiction; otherwise not. Appellant argues the question in his Second Brief (pp. 33-39). Appellant there cites as authority:

Sec. 128(a) of the *Judicial Code*;

Ex parte Norton, 108 U. S. 237, 242;

Bray v. Staples, 180 F. 321, 330;

City of Eau Claire v. Payson, 107 F. 552, 557;

Potter v. Beal, 50 F. 860.

In the excerpts quoted by appellant from the opinions in these four cases, nothing more definite is announced than that a decree is final when nothing remains but to enforce execution; that a decision is final when the full measure of the rights of the parties is determined; that a reasonable construction should be given the term “final decree”, and that the name applied to the decree does not determine its finality.

The position of appellant is summarized (2d Br. 38) as follows:

“We submit as a matter of logic, common sense and practical interpretation of both the letter and the spirit of the new rules governing federal district court procedure that this order and judgment was a final decision by the District Court for the purpose of an appeal therefrom to this Court under the provisions of Section 128(a) of the *Judicial Code*, as amended.”

Counsel for appellant may be correct in this statement. If in support of the statement counsel had cited authorities interpreting "the new rules", such opinions undoubtedly would have been helpful. We should have read with interest and instruction appellant's analysis of the opinion of this court in

Palmuth et al. v. United States, 107 F. (2d) 975
(aff'd *Cobbledick v. United States*, 309 U. S.
323).

In the *Palmuth-Cobbledick* case the appeal was from an order denying motion to quash subpoenas *duces tecum* issued out of the District Court directing attendance upon and production of documents before a federal grand jury. The factual difference between that case and the one at bar is the single circumstance that here the order of the District Court required attendance and production of documents before an Internal Revenue Agent conducting a proceeding "in the matter of the taxpayer's 1930 income tax liability" (2d Br. 4). If that factual difference confers jurisdiction in the case at bar, then (assuming jurisdiction in the District Court in the first instance) jurisdiction of the present appeal appears; otherwise not. From the opinion of this court in the *Palmuth-Cobbledick* case, we quote:

"Appellants have not brought or had occasion to bring any suit or proceeding to recover their papers. *The denial of motions to quash the subpoenas was not a dismissal of any suit or proceeding.* Appel-

lants may, notwithstanding such denial, disregard the subpoenas and, if prosecuted for contempt, may again challenge their validity—thus, in effect, renewing the motions to quash—and, if convicted, may appeal. Upon such appeals, and not otherwise, the denial of the motions may be reviewed by this court.”

107 F. (2d) 976.

There is language in the opinion of the Supreme Court in the *Cobbledick* case which may justify, if not compel, the conclusion that the factual difference just previously mentioned confers jurisdiction in the case at bar. We quote:

“Appeal from an order under Sec. 12 was again here in the *Ellis* case, *supra* [237 U. S. 434, 59 L. Ed. 1036, 35 S. Ct. 645], fully argued in the briefs, and again differentiated from a situation like that in the *Alexander* case. ‘No doubt’ was felt that an appeal lay from the district court’s direction to testify. ‘*It is the end of a proceeding begun against the witness*’—was the pithy expression for this type of case. 237 U. S. at 442 [59 L. Ed. 1040, 35 S. Ct. 645]. *And it is a sufficient justification for treating these controversies differently from those arising out of court proceedings unrelated to any administrative agency.* The doctrine of finality is a phase of the distribution of authority within the judicial hierarchy. *But a proceeding like that under Sec. 12 of the Interstate Commerce Act may be deemed self-contained, so far as the judiciary is con-*

cerned—as much so as an independent suit in equity in which appeal will lie from an injunction without the necessity of waiting for disobedience. After the court has ordered a recusant witness to testify before the Commission, there remains nothing for it to do. Not only is this true with respect to the particular witness whose testimony is sought; there is not, as in the case of a grand jury or trial, any further judicial inquiry which would be halted were the offending witness permitted to appeal. The proceeding before the district court is not ancillary to any judicial proceeding. So far as the court is concerned, it is complete in itself.”

309 U. S. 323, 329-330.

See also:

McCrone v. United States, 307 U. S. 61, 63;

Brownson v. United States, 32 F. (2d) 844, 846 (C. C. A. 8);

Pacific Mills v. Kenefick, 99 F. (2d) 188 (C. C. A. 1);

Farmers' & Mechanics' National Bank v. United States, 11 F. (2d) 348 (C. C. A. 3);

Cf: Lowell Sun Co. v. Fleming, 120 F. (2d) 213, 214 (C. C. A. 1), (*aff'd Holland v. Lowell Sun Co.*, 314 U. S., 62 S. Ct. 793).

Because of comments made during previous oral argument, we felt it our duty to submit the foregoing discussion of jurisdiction.

POINT II.

There Has Been No Sufficient Showing of Reasonable Ground for Suspicion of Fraud or Probable Cause for Suspicion Thereof to Justify a Reexamination of Appellee Chandis' Records.

Analysis of Appellant's Alleged Grounds for Suspicion of Fraud.

Petition for Production of Records and Affidavits in Support Thereof [R. 2].

The petition to the District Court asserts no fraud; it states only that Mrs. Chandler's 1930 return is under investigation [R. 4].

1. *Agent Williams' Affidavit.*

Revenue Agent Williams' affidavit of March 4, 1940 (Ex. C to the petition), contains the affiant's conclusion that examination of Chandis' old records is necessary to determine whether Mrs. Chandler "committed a fraud by failing to report" the receipt of asserted interest income in 1930 [R. 13].

The foregoing comprises the showing made by petitioner upon his *ex parte* application for issuance of the subpoena. After the filing of appellees' Notice of Motion to Quash, appellant filed the following additional affidavits:

2. *Agent Donnally's Affidavit* [R. 73].

Revenue Agent Donnally's affidavit of April 5, 1940, states that appellee Downing in September, 1931, told him the notes were cancelled in 1929, and that he relied upon this "misrepresentation" in making his recommendation that the exchange constituted a taxable transaction in 1929

[R. 74-76]. Downing unequivocally denied Agent Donnally's statement [R. 136]. Regarding this claimed misrepresentation, the District Judge declared:

"Assuming the truth of the statement, there is no allegation that it was made fraudulently or with intent to conceal any facts or to deceive the government into inaction beyond the period of limitation.

"If it was a mere mistake, it could not amount to fraud or give rise to suspicion of fraud."⁸

[R. 155]

Never until subsequent to filing the Motion to Quash had Agent Donnally contended he had been misled by Downing. That Agent Donnally could not have been misled is persuasively shown by the following written data:

a. Chandis' balance sheet attached to its 1929 return, filed March 15, 1930, and reviewed April 12, 1932 [R. 240], showed that at the end of the tax year unsecured notes were outstanding in the amount of \$3,515,606.88, and that the capital stock liability was the same as in previous years [R. 241].

b. Mrs. Chandler's 1929 return was filed the same day as Chandis' 1929 return [R. 100]; both were filed in the Los Angeles office and both were subject to further consideration by the Los Angeles office during the month of October, 1930, as indicated by the endorsement stamp on the face of the returns [R. 100, 240]; Donnally has been assigned to the Los Angeles office *since 1920* [R. 73-74]. Donnally's report of

⁸Citing *Southern Development Co. v. Silva*, 125 U.S. 247, 250; *Reader v. Rorick*, 92 F. (2d) 140, 145 (C.C.A. 6); *Roosevelt v. Missouri Life Ins. Co.*, 78 F. (2d) 752, 757 (C.C.A. 8); the rule is stated in Paul and Mertens' *Law of Federal Income Taxation*, p. 418, as follows: "Generally speaking there must be an *intent* to mislead or defraud."

November, 1931, on Mrs. Chandler's 1929 return recites that "all interest items have been checked" [R. 82-85]; Donnally examined Chandis' records and its 1929 income tax return at the time he examined Mrs. Chandler's 1929 return and verified the interest items [R. 137-138].

c. Mrs. Chandler's Supplemental Protest of the proposed 1929 deficiency (*which the Government received one year prior to the running of the statute of limitations on Mrs. Chandler's 1930 return*) expressly stated that she and the children were on December 31, 1929, the owners of notes which, with principal and interest, had a face value of \$3,515,606.88 [R. 90-91].

d. In Mrs. Chandler's original Petition for Redetermination filed prior to October 20, 1932 [R. 21],⁹ she states on three occasions that interest had accrued to *December 31, 1929*, in the amount of \$661,369.56 [R. 7, 8, 11].⁹

e. During the hearing before the Board of Tax Appeals involving the 1929 deficiency, Downing testified that he had not told Donnally the notes were cancelled in 1929—*Donnally was present at this hearing* when Downing so testified—but Donnally sat mute and did not take the stand to deny Downing's testimony! [R. 137]

Agent Donnally is an able and experienced government accountant. He would not have relied on oral statements concerning "interest income" exceeding \$600,000.00. He

⁹These record references are to the Transcript of Record in Case No. 8262, *Commissioner of Internal Revenue v. Marian Otis Chandler* (C.C. A. 9); in the interest of economy the original petition was not printed, but it is part of the certified record.

would have examined the written records which were readily accessible and with which he was familiar.

3. *Agent Williams' Affidavit* [R. 76].

Agent Williams' affidavit of April 6, 1940, does not aver any grounds for suspicion of fraud. It states that the examination is necessary to determine:

- (1) How much interest Mrs. Chandler should have reported, and
- (2) The value of the stock she received.

Aside from the fact that these desires do not constitute a showing of grounds for suspicion of fraud, the historical background definitely refutes the reasons assigned.

**Amount of Interest Accrued
on Mrs. Chandler's Notes Long
Known to Commissioner.**

For years the Commissioner has known the amount of interest which had accrued on Mrs. Chandler's notes.¹⁰ He had from year to year levied deficiencies based upon these annual interest items, and in April, 1932, advised Mrs. Chandler that the deficiencies for all prior years had been aggregated and assessed against her for 1929; he stated the amount of interest received from Chandis to be \$661,369.56 [R. 93-94]. In the Statement attached to his Letter of Final Determination, dated July 1, 1932, he again stated that Mrs. Chandler received interest income in the amount of \$661,369.56 [R. 69]. The stipulation

¹⁰In Second Brief for Appellant counsel states on six occasions that the amount accrued on Mrs. Chandler's notes was \$661,369.56 (2d Br., pp. 10-11, 14, 46, 49, 60.)

executed by the Commissioner at the time of the 1929 deficiency hearing recites that interest received by Mrs. Chandler was in the same amount [R. 44-45].

The opinion of the Board of Tax Appeals also finds this sum as the amount of interest accruing on the notes owned by Mrs. Chandler [R. 51-52].

**The Commissioner Has Stipulated
to the Value of the Stock Received
in Exchange for the Notes.**

The assertion that examination is necessary to determine the value of the stock is equally lacking in persuasiveness. In 1932 the Internal Revenue Agent advised Mrs. Chandler that the value of the stock would be considered "as equivalent to the total amount of the interest" [R. 92]. Appellant points out (2d Br. 11) that during the hearing on the 1929 deficiency, the Commissioner and Mrs. Chandler stipulated the value of the stock to be \$60.00 per share¹¹ [R. 177], and the Board so found [R. 55-56]. In view of this stipulation, and in view of the right of the Commissioner to assume that the stock is equal to its par value, it is apparent that the true reason for desiring the examination is not to determine the value of the stock.

4. *Agent Donnally's Affidavit* [R. 141].

Agent Donnally's affidavit of May 2, 1940, contains no averments relating to fraud or suspicion thereof.

¹¹Based on this value, the taxable gain, if any, would have been \$72,546.91 (value of stock, \$883,233.97, less cost of notes \$810,687.06); taxable at 12½% (Sec. 101(a), Revenue Act 1928).

5. *Agent Williams' Affidavit* [R. 148].

Agent Williams' affidavit of May 9, 1940, consists principally of references to sections of the Revenue Act and some legal conclusions. He states that the Internal Revenue authorities "have a strong suspicion" that Mrs. Chandler's failure to report the interest income was due to fraud [R. 149], but avers no facts in this respect. Although in previous years Mrs. Chandler had never reported the interest as income, the Commissioner had never charged her with fraud. He did not charge her with fraud in 1929, although she had not reported the interest as income. Now for the first time he makes this untimely assertion, but gives no facts remotely tending to substantiate it when viewed in their context of admitted prior events.

**Mrs. Chandler Believed, in Good Faith,
That Her Acquisition of Stock
Did Not Result in Income.**

Prior to the reorganization of Chandis and the exchange of new stock in payment of the notes, Chandis' fiscal officer consulted income tax advisers of recognized standing and was informed that the contemplated transaction would not result in gain or loss to Chandis or the persons to whom the new stock was to be issued [R. 35-36], and Mrs. Chandler in her Protest [R. 88] informed the Revenue Agent and the Commissioner of her belief that the exchange was nontaxable. It is immaterial, so far as fraud is concerned, whether the opinion of the income tax counselors was correct. Failure to report as income property which a taxpayer in good faith does not consider

income and concerning which the law is not settled is no indicia of fraud.

“It is not inconsistent with good faith that the taxpayer, being ignorant of the regulations and the law generally, sought expert advice and relied upon it. He was not bound to determine a doubtful question against himself, and, in the last analysis, there was no actual concealment. *The returns were all filed on the same day with the same official.*”

Jemison v. Commissioner, 45 F. (2d) 4, 6 (C. C. A. 5).

Accord:

Rogers Recreation Co. v. Commissioner, 103 F. (2d) 780, 783 (C. C. A. 2).

In 1935 the Board of Tax Appeals held that an exchange such as here involved was a tax-free exchange under Sec. 112(b)(3) of the Revenue Act of 1928 and resulted in neither taxable gain nor loss.¹² The facts were that the taxpayer and his brother owned in equal parts all but two shares of the capital stock of a family corporation, and they, together with their wives, held notes issued by the family corporation. The taxpayer exchanged the notes for new stock in the corporation. The holding was that the taxpayer was not entitled to take as a loss the difference between the unpaid principal on the notes and the agreed value of the new stock as of the date of the exchange. The Commissioner acquiesced in this decision

¹²*Burnham v. Commissioner*, 33 B.T.A. 147; affirmed 86 F. (2d) 776 (C.C.A. 7), certiorari denied 300 U.S. 683.

[R. 31].¹³ If the Commissioner believed that the *Burnham decision* was correct, how can he consistently say that he suspects Mrs. Chandler guilty of fraud because of not reporting as income the value of stock received in exchange for cancellation of her notes?

Mrs. Chandler's Protest, her Supplemental Protest, and her Amended Petition for Redetermination of the 1929 deficiency all asserted that the recapitalization of Chandis and exchange of notes for stock constituted a nontaxable exchange in connection with a reorganization within the purview of Sec. 112(b)(3), Sec. 112(b)(5) and Sec. 112(i)(1) of the *Revenue Act of 1928* [R. 88, 91, 95, 166].¹⁴

**District Court Held No Showing of
Probable Cause of Suspicion of Fraud.**

The District Court concluded that appellant had failed to show reasonable grounds for suspicion of fraud, saying:

"The petition and affidavits do not state facts 'showing reasonable grounds of suspicion or probable cause for the examination to ascertain if there has been fraud' * * *.

"Neither the affidavit of Agent Warner E. Williams * * * nor the affidavits of Agent Charles

¹³*Cumulative Bulletin* 1937-2, p. 281, July to December rulings, Ct. D. No. 1245.

¹⁴Sec. 112(b) (3) *Revenue Act of 1928*: "No gain or loss shall be recognized if stock or securities in a corporation a party to a reorganization are, in pursuance of the plan of reorganization, exchanged solely for stock or securities in such corporation * * *."

Sec. 112(b) (5): "No gain or loss shall be recognized if property is transferred to a corporation by one or more persons solely in exchange for stock or securities in such corporation, and immediately after the exchange such person or persons are in control of the corporation * * *."

Sec. 112(i) (1): "The term 'reorganization' means * * * (C) a recapitalization, or (D) a mere change in identity, form, or place of organization, however effected."

W. Donnally * * * nor the affidavit and exhibits filed with the petition allege facts sufficient to show grounds of suspicion or of probable cause for fraud.”

[R. 155.]

We have heretofore (*ante*, pp. 16 to 22) analyzed in detail and commented upon appellant’s petition and affidavits. They fall far short of a showing of reasonable grounds for suspicion of fraud or probable cause for suspicion thereof.

“Mere affirmance of belief or suspicion” of the existence of fraud will not justify the issuance of a subpoena *duces tecum*, which in scope and effect amounts to a general search warrant.

Nathanson v. United States, 290 U. S. 41, 47.

In *Matter of Andrews’ Tax Liability*, 18 F. Supp. 804 (D. C. Md.), reexamination of a taxpayer’s books for 1931, subsequent to the running of the statute of limitations, was not permitted because the Commissioner had made no showing of reasonable ground of suspicion of fraud or probable cause of fraud with respect to the year 1931.

In *Zimmermann v. Wilson*, 81 F. (2d) 847 (C. C. A. 3), an attempted reexamination of records after the statute of limitations had run was enjoined because the revenue authorities had failed to make any claim or showing of fraud on the part of the taxpayer.

In *Matter of Morris & Cummings Dredging Co.*, an unreported decision¹⁵ of the District Court, Southern Dis-

¹⁵The opinion will be found in 9 *American Federal Tax Reports*, 1665.

trict of New York, the Internal Revenue Agent sought to examine documents relating to the taxpayer's liability for 1916 taxes. The government's application was made in 1930, although the taxpayer had filed its return in 1917. The statute of limitations had run. The District Judge proceeded in the same manner as did the District Court at bar. An *ex parte* order for production of the records had been made, but a motion to vacate the order was granted, the court saying:

"On the present papers, however, there is no proof of the fraudulent intent which is necessary to remove either the three-year or the five-year period of limitation. It would certainly be unjust to permit the government after fourteen years to examine the taxpayer's officers and inspect its books unless there had been fraud. I will therefore grant this motion, *unless the government presents further proof of the taxpayer's fraud.*"

9 A. F. T. R. 1665-1666.

The recent decision (May, 1941) in *In re Brooklyn Pawnbrokers, Inc.*, 39 F. Supp. 304 (D. C. N. Y.), is squarely in point and aptly states the settled rule. There records covering the tax years 1930 to 1938 were subpoenaed and a motion to vacate made. In granting the motion

"without prejudice to the right of the government to seek an examination upon setting forth facts affording reasonable basis for a suspicion of fraud"

the court declared:

"It has become a general rule of practice for the courts to deny the government examinations in connection with tax years as to which the statute of limitations has run, except in fraud cases. * * *

* * * * *

“In the case at bar, the government’s affidavit in support of its examination states only ‘that the taxpayer wilfully and fraudulently understated its gross income for the years involved.’ This is little more than the statement of a conclusion. Certainly *it is no undue burden to require the government to set forth facts leading it to suspect that there may have been fraud.*”

39 F. Supp. 304-305.

To constitute probable cause, the showing must be

“such that a reasonably discreet and prudent man would be led to believe that there was a commission of the offense charged, * * *.”

Dumbra v. United States, 268 U. S. 435, 441.

The showing made must be of

“facts—not suspicions, beliefs, or surmises. * * *
A mere conclusion is insufficient either in the affidavit or the complaint.”

Wagner v. United States, 8 F. (2d) 581, 583 (C. C. A. 8).

As pointed out by the trial judge, the only claimed showing of a suspicion of fraud is the belated and contradicted assertion of Agent Donnally that he had been misinformed in 1931 respecting the date of cancellation of the notes, but there was no averment that such statement was made with intent to mislead or defraud the Commissioner [R. 155]. There has been no explanation why the government waited until November 30, 1939, to make its reinvestigation when it knew at least as early as 1933 (at the time of the hearing before the Board of

Tax Appeals) that Mrs. Chandler was contending the transaction occurred in 1930 rather than 1929; in fact, the authorities were so advised in March, 1932, by Mrs. Chandler's Supplemental Protest [R. 90, 91]. Donnally, it will be remembered, attended the hearing before the Board of Tax Appeals and was in court at the time Downing denied that he told Donnally the notes were cancelled in 1929, but Donnally remained mute [R. 137, 142].

The District Judge properly declared that the Revenue Agents were not the sole judges as to the scope of the examination which they desired to conduct [R. 156]. Sec. 3614 of the *Internal Revenue Code*¹⁶ does not give Revenue Agents *carte blanche* authority to reexamine any records which they wish or permit the Commissioner's determination of necessity to be considered conclusive. Sec. 3614 is restricted not only by Sec. 3631,¹⁷ but in itself confines the examination to "*publications, papers, records or memoranda bearing upon the matters required to be included in the return.*" Appellant admittedly is not conducting the examination for this reason, but, he says, for the purpose of making a roving investigation to determine, first, how much interest Mrs. Chandler should have reported in her 1930 return and, second, the value of the stock she received [R. 77]. These ostensible reasons, we believe, have previously been shown to be wholly lacking in merit (*ante*, pp. 19 and 20).

¹⁶Sec. 3614: "The Commissioner, for the purpose of ascertaining the correctness of any return * * * is authorized * * * to examine any books, papers, records, or memoranda bearing upon the matters required to be included in the return * * *."

¹⁷Sec. 3631: "No taxpayer shall be subjected to unnecessary examinations or investigations * * *."

In *McDonough v. Lambert*, 94 F. (2d) 838 (C. C. A. 1), the court reversed the District Court's denial of a motion to vacate an order granting a subpoena *duces tecum* which required production of documents in connection with the tax liability of the McDonough Company *and others*. The subpoena had been served upon the treasurer of the McDonough Company. The Internal Revenue Agent conceded that none of the documents subpoenaed could affect the tax liability of the corporation (94 F. (2d) 840). The District Court, concluding that the information sought might affect the tax liability of other persons, held the subpoena proper. The Circuit Court of Appeals declared:

"We do not think the provisions of this section [3614] can be given such a broad construction; that by its terms it is more limited in scope and confined to the procurement of evidence, oral or documentary, *bearing upon matters required by law to be included in a given tax return* * * *."

94 F. (2d) 841.

In that case the Revenue Agents wanted to know who had received a \$10,000.00 fee from the McDonough Company. Here appellant wants to make a search in the hope of uncovering something which may show a tax liability. He has nothing definite in mind, for his brief filed with the trial court declares:

"An examination of the books, *if* it reveals fraud, may reveal *some device* of tax avoidance * * * and *some ground* for tax liability other than the point raised in the *Burnham* case."

(Memorandum of Points and Authorities in Opposition of [*sic*] Motion to Quash Order for Production of Records, p. 34.)

In *Mays v. Davis*, 7 F. Supp. 596 (D. C. Pa.), a Revenue Agent petitioned the court to compel production of corporate records disclosing names and addresses of beneficiaries under trusts created by will. The petition was denied, the court declaring:

“The power of the court to make the order desired is limited as specified in said section 618 [now Sec. 3614] ‘for the purpose of ascertaining the correctness of any return or for the purpose of making a return * * *.’ I am of the opinion that the petition is not authorized by section 618; that *to grant the prayer thereof would be to grant a mere explanatory [sic] search for information on the part of the petitioner*, and that not being within the law that the petition should be refused. It might be added that the information desired can be procured from returns on file in the office of the collector of internal revenue at Pittsburgh.”

7 F. Supp. 596.

Appellant relies on *Zimmermann v. Wilson*, 105 F. (2d) 583 (C. C. A. 3), but the case does not support him. On the contrary, it rather convincingly demonstrates the correctness of the District Judge’s ruling. In the *Zimmermann* case, as the persons complaining of the search did not own the subpoenaed records, it was held they could not invoke the Fourth Amendment. The Revenue Agents restricted their request to stockbrokers’ records for three years—1929, 1930, and 1932. Uncontradicted evidence was introduced showing large sales of stock by a husband and purchases of the same stock by his wife on the same day. As a result the husband reported a net loss in excess of \$146,000.00 for the year 1929, whereas if the sales

were not allowed, he would have shown a net gain of approximately \$271,000.00 (105 F. (2d) 585). The undisputed evidence also showed that the transactions were all conducted by the husband and that *the wife did not know when purchases or sales were made by her*. Under such state of facts, the court held the investigation authorized, but Circuit Judge Biddle warned:

“If they [revenue agents] attempt to examine unrelated transactions, or to engage in an irrelevant, ‘fishing expedition’, as complainants suggest, they may be restrained by the court to whom application is made to enforce compliance.”

105 F. (2d) 583, 585.

In the case at bar Mrs. Chandler, in contrast to Mr. Zimmermann, has not taken any deductions as a result of any of her transactions with Chandis. When Mrs. Chandler sells the stock, she may have a taxable gain.¹⁸ The showing made in the *Zimmermann case*, of reasonable grounds for a suspicion of fraud, is by no means similar to that here presented. This is made abundantly clear from a reading of the opinion. If the court desires to make further comparison, we respectfully refer it to pages 45 to 55, 62, 112, 134 to 136, 208 to 211, 231, and 239 to 242, of the Zimmerman Transcript of Record.¹⁹

¹⁸*Revenue Act 1928*, Sec. 113(6): “If the property was acquired upon an exchange described in section 112(b) to (e), inclusive, the basis shall be the same as in the case of the property exchanged, decreased in the amount of any money received by the taxpayer and increased in the amount of gain or decreased in the amount of loss to the taxpayer that was recognized upon such exchange under the law applicable to the year in which the exchange was made.”

¹⁹* * * it is permissible to examine the record resulting in an opinion, to ascertain the grounds upon which the opinion is based.” (*Atlantic Fruit Co. v. Red Cross Line*, 5 F. (2d) 218, 219 (C.C.A. 2).)

Appellant also cites (2d. Br. 41) *In re Upham's Income Tax*, 18 F. Supp. 737 (D. C. N. Y.), and *In re Keegan*, 18 F. Supp. 746 (D. C. N. Y.).

In *Upham's case* objection was made to the subpoena on the ground it violated the Fourth Amendment. The court held the objector was not entitled to raise the point as she did not own the documents which were sought (p. 738). But appellee Chandis is the owner and possessor of the subpoenaed documents.

Keegan's case did not involve a subpoena *duces tecum*—merely a subpoena *ad testificandum* (pp. 747-748).

Appellant lays frequent stress (2d. Br. 12-13, 20, 46-47, 49) upon the circumstance that Mrs. Chandler's original Protest (December 17, 1931) [R. 87] to the proposed assessment of additional taxes for 1929 contained the assertion that during the calendar year 1929 Chandis had acquired its notes from Mrs. Chandler [R. 88]. It is this statement on which appellant at times seems to rely to show that he has reasonable grounds to suspect fraud, *but no representation was ever made that Mrs. Chandler acquired the new stock during the calendar year 1929.*²⁰ The statement upon which appellant relies has been removed from its context. When viewed and interpreted in light of the surrounding circumstances, there is no basis for the contention that this statement misled the revenue authorities. In the paragraph immediately following that

²⁰It is acquisition of the stock that would give rise to a taxable gain (unless the exchange were nontaxable)—not the surrender by Mrs. Chandler of her notes.

portion of the Protest upon which appellant places reliance, Mrs. Chandler stated:

“The Internal Revenue Agent has erroneously included this sum as income which was not paid to the taxpayer and was not credited to her account or unqualifiedly subject to her demand.”

[R. 88.]

Does this not mean that the taxpayer was contending that she did not receive taxable income in 1929?

On March 31, 1932, Mrs. Chandler filed a Supplemental Protest (at this time the revenue authorities were still proposing a deficiency only for interest income representing one year's interest), in which she specifically stated:

“* * * the taxpayer and her children *on December 31, 1929, were the owners of notes* executed by the Chandis Securities Company that had a face value, together with accrued interest, aggregating \$3,515,-606.88.”

[R. 91.]

Immediately following was the statement that the notes had been exchanged for stock, but *there was no assertion that the exchange had taken place in 1929*. Appellant's statement (2d Br. 46) that Mrs. Chandler advised the revenue authorities that she had exchanged her notes for stock in 1929 is erroneous.

Subsequent to receipt of the Supplemental Protest, and on April 4, 1932, the local revenue authorities recomputed Mrs. Chandler's tax and then *for the first time* advised her that all interest which had accrued during the years 1916-1929 would be treated as income received in 1929 [R. 92].

Heretofore the revenue authorities had been proposing a deficiency for merely one year's interest—that of 1929 [R. 80, 82], but at this time they changed their theory and asserted that the interest for all years from 1916 to 1929 had been received in 1929, saying:

“Consideration has been given to the seeming unfairness of proposing a deficiency for the taxable year while deficiencies for prior years based on the same items were still pending, but it is only by so doing that the matter could be placed in position for a complete settlement of the interest question * * *.”

[R. 93.]

Appellant suggests (2d Br. 48), although nothing in the record justifies it, that Mrs. Chandler purposely waited until the statute of limitations had run against additional assessment of tax for the year 1930 before filing her amended petition with the Board of Tax Appeals wherein she alleged that if the exchange resulted in taxable income, the income was taxable in 1930—not in 1929. The fact of the matter is, as stated by appellant (2d Br. 48), the amendment was filed upon the suggestion of a new attorney shortly following his association in the case; prior to filing the amendment, the attorney discussed the matter with Mr. Leming, counsel for the Commissioner [R. 201-202]. Actually Mrs. Chandler did not change her theory by filing the Amended Petition for Redetermination wherein she specifically alleged that the transaction occurred in 1930—not in 1929 [R. 167]. In her original

Petition for Redetermination she stated three times that the interest on the notes had accrued to December 31, 1929 [R. 7, 8, 11],²¹ in her original Protest she stated that the accrued interest "was not credited to her account or unqualifiedly subject to her demand" [R. 88], and in the Supplemental Protest that she owned the notes on December 31, 1929 [R. 91]. Such statements, we submit, are not susceptible of any interpretation other than that Mrs. Chandler was contending that she had not received income in 1929 as a result of the reorganization of Chandis.

If the revenue authorities had deemed themselves misled or prejudiced by Mrs. Chandler's prior conduct, would not objection to the amendment have been interposed? Would they not have asserted an estoppel²² to contend that the transaction occurred in 1930 on the ground that the statute had run as to that year? This was not done, the logical explanation being that the revenue authorities were proceeding on the theory that, irrespective of the actual date of cancellation of the notes and issuance of new stock, the arrangement had been legally completed in 1929 [R. 194-196].

And if fraud was suspected, why did the Commissioner wait until 1940 to assert it?

²¹These record references are to Case No. 8262 as explained (*ante*, p. 18, footnote 9).

²²If the Commissioner had deemed the government prejudiced by Mrs. Chandler's "change of position," he could with propriety and with success have asserted an estoppel (*Portland Oil Co. v. Commissioner*, 109 F. (2d) 479, 485-486 (C.C.A. 1), certiorari denied 310 U.S. 650).

POINT III.

The Subpoena Is Unreasonable and Oppressive; It Is Unlimited in Scope and Lacking in Particularity and It Embraces an Excessive Period of Time; if Enforced It Would Constitute an Unreasonable Search and Seizure of Appellee Chandis' Records in Violation of the Fourth Amendment to the Constitution of the United States and an Abuse of the Process of the Court.

The District Judge's opinion shows he concluded from the record that the subpoena was unreasonable, for he declared:

"The petition and affidavits do not show the need for an examination of *all the fiscal records of the corporation*²³ for the years 1916 to 1930, when the only issue involved is the tax liability of one of its stockholders, Marian Otis Chandler, for the year 1930, by reason of a single transaction, *long known to the Government*²³ and to the agents of the Bureau of Internal Revenue."

[R. 155-156.]

The *Fourth Amendment* guarantees all persons against unreasonable searches and seizures.²⁴ Certain elementary principles concerning this amendment should be briefly stated.

The amendment is to be liberally construed.

Go-Bart Co. v. United States, 282 U. S. 344, 357.

²³Italics are by the court.

²⁴"The right of the people to be secure in their persons, houses, papers, and effects, against unreasonable searches and seizures, shall not be violated." (*United States Constitution, Fourth Amendment.*)

It applies to civil²⁵ as well as criminal proceedings. In *Weeks v. United States*, 232 U. S. 383, 392, the court said of the Amendment:

“This protection reaches all alike, *whether accused of crime or not*, and the duty of giving to it force and effect is obligatory upon all entrusted under our Federal system with the enforcement of the laws.”

It proscribes all process which in effect amounts to a general warrant.

“All unreasonable searches and seizures are absolutely forbidden by the Fourth Amendment. * * *

“The amendment applies to warrants under any statute; revenue, tariff, and all others.”

Nathanson v. United States, 290 U. S. 41, 46-47.

In determining the reasonableness or unreasonableness of a subpoena *duces tecum*.²⁶

“Each case is to be decided on its own facts and circumstances.”

Go-Bart Co. v. United States, 282 U. S. 344, 357.

We have heretofore (*ante*, pp. 4 to 8), pointed out the minute familiarity which the revenue officials have had with the affairs of Mrs. Chandler and Chandis in so far as the reorganization and exchange of stock for notes are concerned. With these facts in mind, and recalling that

²⁵*Cudahy Packing Co. v. United States*, 15 F. (2d) 133, 136-137 (C.C. A. 7); *Federal Trade Commission v. Smith*, 34 F. (2d) 323, 324 (D.C. N.Y.); *Silverthorne Co. v. United States*, 251 U.S. 385, 392.

²⁶We treat the Order for Production of Records as being in substance a subpoena *duces tecum* (*Consolidated Rendering Co. v. Vermont*, 207 U.S. 541, 550).

purportedly appellant is seeking only to investigate the 1930 return of Mrs. Chandler, we list the documents sought to be subpoenaed. They consist of Chandis' records for a fifteen-year period (1916 to 1930), and include:

1. Minute Books;
2. Stock Books;
3. All fiscal records;
4. All vouchers, correspondence, and other written data supporting original entries in the accounting books;
5. All promissory notes of Chandis issued to Mrs. Chandler and the children during the fifteen-year period, which have been paid or otherwise cancelled.

[R. 5.]

Appellant made no effort to restrict his demand to documents pertaining to the 1930 transaction. He not only seeks records concerning Mrs. Chandler, but also those concerning her eight children. There has been no attempt made to show the probable materiality of these ancient and unrelated documents.

The subpoena is unlimited in scope, is lacking in particularity, and embraces an excessive period of time. There are many announcements of the Supreme Court dealing with this matter, and we have included a brief summary of them in the Appendix. Appellant has not seen fit to discuss any of these cases, although they are the decisions commonly relied on by inquisitorial bodies to sustain their subpoenas.

Although there is no precise formula by which the reasonableness of a search may be determined, the closest approach to one is negatively stated in *Wilson v. United States*, 221 U. S. 361, 376:

“* * * there is no unreasonable search and seizure, when a writ, *suitably specific and properly limited in its scope*, calls for the production of documents which, as against their lawful owner to whom the writ is directed, the party procuring its issuance is entitled to have produced.”

Tested by this criterion, the subpoena here under consideration clearly is violative of the constitutional guarantee. It is neither specific nor limited as to subject matter. It commands the production of all fiscal records embracing a period of fifteen years, and is not properly limited as to time, the records sought reaching back a quarter of a century to the creation of the corporation.

All cases cited by appellant (2d Br. 41, 45) recognize that subpoenas *duces tecum* must not conflict with the constitutional guarantee or be used as a roving commission.

In *Zimmermann v. Wilson*, 105 F. (2d) 583, 585 (C. C. A. 3), Circuit Judge Biddle declared:

“The Fourth Amendment protects against unreasonable searches; and ‘the search is “unreasonable” only because it is out of proportion to the end sought’;
* * * Agents may not ‘under official pretext but in fact officiously, extend their powers beyond those provided by the law. * * *’ * * * If they attempt to examine unrelated transactions, or to engage in an irrelevant ‘fishing expedition’, as complainants suggest, they may be restrained by the court to whom application is made to enforce compliance.”

In *McMann v. Engel*, 16 F. Supp. 446, 447-448 (D. C. N. Y.), the court said:

“* * * a compulsory production of private papers pursuant to subpoena may amount to an unreasonable search and seizure of a person’s papers, contrary to the Fourth Amendment. The deciding factor, in last analysis, is the reasonableness of the subpoena. * * * *Where the order for production of papers is the equivalent of a general warrant, the person whose papers are demanded will be given relief by the courts.*”

In *McMann v. Securities and Exchange Commission*, 87 F. (2d) 377, 379 (C. C. A. 2), the court said:

“No doubt a subpoena may be so onerous as to constitute an unreasonable search. * * * the search is ‘unreasonable’ only because it is out of proportion to the end sought, as *when the person served is required to fetch all his books at once to an exploratory investigation whose purposes and limits can be determined only as it proceeds.*”

In *United States v. Union Trust Co.*, 13 F. Supp. 286 (D. C. Pa.), the Board of Tax Appeals issued a subpoena *duces tecum* to compel production of corporate minutes for the years 1931 and 1932. The subpoena was issued during the course of a hearing to determine whether a third party had been guilty of fraud. Of one paragraph the court declared:

“This paragraph is a blanket demand for the production of the minutes of the Union Trust Company for the years 1931 and 1932. Lacking specification as it does, the paragraph is violative of the rights of

POINT IV.

Chandis, the Possessor and Owner of the Documents Subpoenaed, Is Entitled to Challenge the Validity of the Subpoena Duces Tecum.

Appellant asserts (2d Br. 55-56) that he is investigating Mrs. Chandler's return—not Chandis' return—and therefore Chandis may not complain of the unreasonableness, untimeliness, or the futility of the subpoena. No authority is cited which supports this contention. If such were the rule, the provisions of the Fourth Amendment against unreasonable searches and seizures might readily be circumvented by purportedly conducting an investigation of the return of one person and seeking in the course thereof to examine documents belonging to another.

In *United States v. Union Trust Co.*, 13 F. Supp. 286 (D. C. Pa.), it was held that the revenue authorities, in attempting to examine records belonging to a corporation during the course of their investigation of the tax return of an individual, were bound by the mandate of the Fourth Amendment.

Appellant's Authorities Analyzed and Distinguished.

Zimmermann v. Wilson, 105 F. (2d) 583 (C. C. A. 3), held that persons not the owners of documents subpoenaed could not object to their production. This is not that kind of a case.

In re Upham's Income Tax, 18 F. Supp. 737 (D. C. N. Y.), is similar to the *Zimmermann case*, the party objecting not being the owner of the records.

In re Keegan, 18 F. Supp. 746 (D. C. N. Y.), did not concern a subpoena *duces tecum*, merely one *ad testificandum*.

Caplis v. Helvering, 4 F. Supp. 181 (D. C. N. Y.), was a plenary action to restrain the Commissioner from serving a subpoena on the plaintiff in connection with the Commissioner's investigation of the tax liability of a deceased person. *It does not appear that any subpoena duces tecum was involved*. The court held that plaintiff could not claim the Collector had acted in excess of his powers in issuing a summons merely because the statute of limitations had run against the decedent's estate. This principle is not disputed here. *The controlling criterion in a case wherein the Fourth Amendment is properly invoked is whether the subpoena is reasonable*. The circumstance that in the absence of proof of fraud on the part of Mrs. Chandler in her 1930 return, no further tax can be collected from her for that year is a persuasive, and we think a compelling, reason for holding that the attempted search is unreasonable—particularly when viewed in light of the facts and records now in the possession of the revenue authorities, their past familiarity with the single transaction here involved, and the all-embracing scope of the subpoena which the District Judge quashed.

United States v. American Exchange Irving Trust Co., 43 F. (2d) 829 (D. C. N. Y.), and *United States v. First Capital National Bank*, 89 F. (2d) 116 (C. C. A. 8), did not involve the Fourth Amendment. They hold that in distraint proceedings the party distrainted (a debtor of the delinquent taxpayer) could not assert that the statute of limitations had run against collection of the tax. These cases are analogous to those holding that a person not the

owner of records sought to be subpoenaed cannot complain of the unreasonableness of the subpoena. In these distraint cases it was no concern of the banks to whom they paid the amounts on deposit. Payment pursuant to law would operate as a discharge of their obligation to their depositors.

Entirely aside from the constitutional guarantee, there are further compelling reasons why Chandis may properly challenge the validity of the subpoena.

The Investigation Here Sought, Although Ostensibly One Concerning Mrs. Chandler, Is Actually an Investigation in Connection With the Tax Returns of Chandis for the Years 1916 to 1930.

The practical effect of the subpoena would be to permit the revenue authorities to accomplish by indirection that which cannot be directly done. Appellant is really interested in making this examination in order to look into the returns of Chandis for many years past. The record discloses the following:

November 10, 1939—Appellant serves Chandis with a letter dated *June 15, 1937*, requesting reexamination of its records in connection with its own tax returns for the years 1916 to 1930 [R. 25, 37].

November 28, 1939—Chandis advises Commissioner that it will not accede to his request [R. 25, 38].

November 30, 1939—Commissioner serves on Mrs. Chandler a letter dated *March 31, 1938*, requesting reexamination of her 1930 return [R. 9, 25]. On this same date, and without waiting for Mrs. Chandler to indicate her compliance or rejection of his request, the

Commissioner (acting through appellant) serves an administrative summons on Chandis in connection with its returns for the years 1916 to 1930 [R. 25, 26, 40], and another administrative summons on Chandis with respect to Mrs. Chandler's 1930 return [R. 4-5, 10].

December 11, 1939—Chandis declines to permit Commissioner to examine its records in connection with its tax returns for the fifteen-year period [R. 41].

March 5, 1940—Appellant files Petition for Production of Records [R. 13].

The revenue authorities have never notified Chandis of any intention to abandon their examination of its old returns embracing this lengthy period [R. 26].

The foregoing chronology indicates rather persuasively that it is with Chandis' returns that the revenue authorities are in fact concerned—not Mrs. Chandler's return for one year. As pointed out by the District Court,

“The petition and affidavits do not show the need for an examination of *all the fiscal records of the corporation*²⁹ for the years 1916 to 1930, when the only issue involved is the tax liability of one of its stockholders, Marian Otis Chandler, for the year 1930, by reason of a single transaction, *long known to the Government*²⁹ and to the agents of the Bureau of Internal Revenue.”

[R. 155-156.]

²⁹Italics are by the court.

The single transaction referred to by the District Court related to the exchange, pursuant to the recapitalization of Chandis, of its new stock for its old stock and notes, plus accrued interest. The purpose of appellant is further emphasized by the following quotation from his brief (2d Br. 61):

“Chandis has already had the benefit of deductions from its own gross income with respect to the interest transactions between itself and its principal stockholder now under investigation. Surely the Commissioner is now entitled to the aid of the courts in this proceeding where his sole purpose is to enable him to ascertain and determine the real substance and tax consequences of this same long series of interest transactions * * *.”

The “tax consequences of this same long series of interest transactions” certainly cannot affect Mrs. Chandler’s income tax liability for the year 1930. We have heretofore pointed out to the court that the Board of Tax Appeals for the years 1920 to 1927, inclusive, has long since made final determinations of her “tax consequences of this same long series of interest transactions” (1920 to 1923 [R. 58]; 1923 to 1927 [R. 139-140]). The action of the Commissioner proposing the additional taxes for the year 1928 was abandoned by him when he issued his deficiency letter [R. 67] for the year 1929; and for the year 1929 the Board of Tax Appeals’ decision that Mrs. Chandler derived no taxable income during that year has become final. Consequently, the only “tax consequences” that could arise from this “same long series of interest

transactions” would be the tax consequences of Chandis Securities Company. The deductions taken by Chandis of the accrued interest were permitted by Sec. 23(b), Revenue Act of 1928 (*ante*, p. 40, footnote 27).

In view of the foregoing, it is obvious that appellant could not reasonably be interested in the effect upon Mrs. Chandler’s return for 1930 of this “same long series of interest transactions.”

It was not until after Chandis had declined to submit to reexamination that appellant served a letter on Mrs. Chandler advising her that reexamination would be made, and concurrently therewith served two administrative summonses on Chandis, one relating to its returns (1916-1930), the other to Mrs. Chandler’s 1930 return. The nature of the documents required by the summonses further confirms the assertion that it is Chandis—not Mrs. Chandler—that is under investigation. If this were not so, there would clearly be no occasion for seeking examination of records referring to the Chandler children and not to Mrs. Chandler. Appellant has never attempted to explain why the dealings of Chandis with the Chandler children over the fifteen years involved (1916-1930) have any bearing upon matters required to be included in Mrs. Chandler’s 1930 return. Nor has appellant ever indicated a desire to make a reexamination relative to the returns of the children [R. 36].

If further evidence is required to convince that it is Chandis—not Mrs. Chandler—that is the object of the attempted investigation, it will be found in the record. The Order for Production of Records [R. 15] calls for documents not included in the administrative summons which appellant served on Chandis in connection with his

Appellant does not assert that any matters required to be included in Mrs. Chandler's 1930 return were omitted. He could not successfully do so in view of the decision in *Burnham v. Commissioner*, 33 B. T. A. 147 (affirmed 86 F. (2d) 776 (C. C. A. 7), certiorari denied 300 U. S. 683), in which decision the Commissioner has acquiesced (*ante*, p. 23). And under the express mandate of the statute, *Revenue Act of 1928*, Sec. 112(3)(5) (*ante*, p. 23), the transaction here involved clearly did not result in any taxable gain or loss. The appellant's authority in this proceeding is conferred by Sec. 3614, and when the person whose records are subjected to subpoena challenges his authority, he is, we submit, required to establish that it exists before he is entitled to proceed.

After appellees challenged the propriety of the investigation, appellant's assistants filed a further affidavit stating that the reason for the investigation is to determine how much interest Mrs. Chandler should have reported and the value of the stock she received [R. 77]. As previously pointed out (*ante*, pp. 19 to 20), these ostensible reasons are lacking in merit for these facts are well known to the Commissioner. But even though Mrs. Chandler should have reported the receipt of the stock in her 1930 return, what bearing would records for fourteen years prior to 1930 and the dealings of Chandis with the Chandler children have upon Mrs. Chandler's return?

A roving inspection, such as is here sought, will not be tolerated, particularly when the tax officials have at their command full information concerning the matter allegedly under investigation.³²

³²This matter has previously been developed (*ante*, pp. 28 and 29).

Conclusion.

We asserted below without contradiction, and we here reassert, that appellant can cite no decision wherein a search embracing such an unreasonable period of time, so lacking in definiteness and calling for all fiscal records of a corporation, has been sanctioned. The subpoena is the equivalent of a general search warrant, which the Supreme Court has unequivocally condemned (*Boyd v. United States*, 116 U. S. 616, 624-630, 635). Constitutional guarantees must not be sacrificed to expediency.

“The Fourth Amendment, which prohibits unreasonable searches and seizures, is one of the pillars of liberty so necessary to a free government that expediency in law enforcement must ever yield to the necessity for keeping the principles on which it rests inviolate.”

United States v. 1013 Crates of Whiskey Bottles,
52 F. (2d) 49, 51 (C. C. A. 2).

The trial court properly concluded that appellant did not make a showing of reasonable grounds or probable cause for suspicion of fraud. Undisputed documentary evidence abundantly establishes the correctness of this conclusion. The order should be affirmed.

Respectfully submitted,

A. CALDER MACKAY,

T. B. COSGROVE,

F. J. O'NEIL,

F. B. YOAKUM, JR.,

*Attorneys for Appellees Chandis Securities Company and
H. E. Downing.*

APPENDIX.

Summary of Supreme Court Decisions Establishing Criteria for Determining Reasonableness of a Subpoena Duces Tecum.

Hale v. Henkel, 201 U. S. 43 (1906).

The grand jury subpoena required production of:

(1) All understandings, agreements, arrangements or contracts between MacAndrews etc. Co. and six other firms from the date of organization of MacAndrews etc. Co.;

(2) All correspondence between MacAndrews etc. Co. and six other firms;

(3) All reports or accounts from the six firms to MacAndrews etc. Co.;

(4) All letters received by MacAndrews etc. Co. since the date of its organization from thirteen other named companies, and all copies of correspondence with the companies.

The court said:

“* * * an order for the production of books and papers may constitute an unreasonable search and seizure within the Fourth Amendment. While a search ordinarily implies a quest by an officer of the law, and a seizure contemplates a forcible dispossession of the owner, still, as was held in the *Boyd case*, the substance of the offense is the compulsory production of private papers, whether under a search warrant or a *subpoena duces tecum*, against which the person, be he individual or corporation, is entitled to protection. Applying the test of reasonableness to the present case, we think the *subpoena duces*

tecum is far too sweeping in its terms to be regarded as reasonable.

* * * * *

“* * * A general subpoena of this description is equally indefensible as a search warrant would be if couched in similar terms.” (201 U. S. 76, 77.)

Consolidated Rendering Co. v. Vermont, 207 U. S. 541 (1908).

A state grand jury, while investigating charges against four persons of selling contaminated meat, issued a subpoena *duces tecum* to produce records from January, 1904, to October, 1906, the date of the notice. The records subpoenaed were confined to transactions with four accused individuals and the cattle commissioners of Vermont (66 Atl. 790; 80 Vt. 55). The court declared:

“The notice also gave in detail the dates and amounts of checks and vouchers which the company was required to produce. * * * We see no reason why all such books, papers and correspondence which related to the subject of inquiry, and were described with reasonable detail, should not be called for and the company directed to produce them. * * * The notice is not nearly so sweeping in its reach as in the case of *Hale v. Henkel*, * * *” (207 U. S. 554.)

Wilson v. United States, 221 U. S. 361 (1911).

A federal grand jury had indicted Wilson, President of the United Wireless Telegraph Company. About two months after finding the indictment, it served a subpoena *duces tecum* on Wilson requiring production of

“Letter press copy books of United Wireless Telegraph Company containing copies of letters and tele-

grams signed or purporting to be signed by the President of said Company during the months of May and June, 1909; * * *.” (221 U. S. 367 (footnote).)

This subpoena was held not to constitute an unreasonable search and seizure, the court saying:

“But there is no unreasonable search and seizure, when a writ, suitably specific and properly limited in its scope, calls for the production of documents which, as against their lawful owner to whom the writ is directed, the party procuring its issuance is entitled to have produced. In the present case, the process was definite and reasonable in its requirements, and it was not open to the objection made in *Hale v. Henkel*, * * *.” (221 U. S. 376.)

The subpoena here only sought documents signed by the person indicted during a two-months period, which period antedated the issuance of the subpoena by eighteen months.

Wheeler v. United States, 226 U. S. 478 (1913).

In April, 1912, a federal grand jury was investigating Wheeler and Shaw (Treasurer and President, respectively, of Wheeler & Shaw, a corporation) to determine whether mail frauds had been committed. It issued a subpoena *duces tecum* directed to these men, requiring them to produce

“* * * all the cash books, ledgers, journals and other books of account of the company, and all copies of letters and telegrams of Wheeler & Shaw, Incorporated, whether signed or purporting to be signed by the corporation or by its president or treasurer in

21
4

United States
Circuit Court of Appeals
For the Ninth Circuit.

ARTESIAN WATER COMPANY, a corporation,
Petitioner,
vs.
COMMISSIONER OF INTERNAL REVENUE,
Respondent.

Transcript of the Record

Upon Petition to Review a Decision of the United States
Board of Tax Appeals.

FILED

JUL 5 1941

PAUL P. O'BRIEN,

United States
Circuit Court of Appeals

For the Ninth Circuit.

ARTESIAN WATER COMPANY, a corporation,
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INDEX

[Clerk's Note: When deemed likely to be of an important nature, errors or doubtful matters appearing in the original certified record are printed literally in *italic*; and, likewise, cancelled matter appearing in the original certified record is printed and cancelled herein accordingly. When possible, an omission from the text is indicated by printing in *italic* the two words between which the omission seems to occur.]

	Page
Answer	12
Answer to Amended Petition.....	19
Appearances	1
Assignment of Errors.....	135
Certificate of Clerk.....	134
Decision	37
Designation of Portions of Record on Review.....	136
Docket Entries	1
Findings of Fact and Opinion.....	21
Notice of Filing Petition for Review.....	41
Opinion	27
Petition	3
Petition, Amended	13
Petition for Review.....	38
Praecipe	132
Review:	
Assignment of Errors on.....	135
Designation of Contents of Record on.....	136
Petition for	38

Index	Page
Praeceptum on (Board of Tax Appeals).....	132
Statement of Points on.....	135
Statement of Points on Review.....	135
Testimony	42
Exhibits for petitioner:	
1—Mortgage Note for \$175,000 due to the Pacific Mutual Life Insurance Company of California by the Artesian Water Company.....	54
2—Note for \$35,000, dated December 18, 1931, due November 12, 1934 given by the Artesian Water Company to the Pacific Mutual Life Insurance Company of California.....	59
3—Order appointing a Receiver in the case of Baldwin vs. Rindge, in the Superior Court of Los Angeles County, No. 390338.....	50
4—Mortgage No. 6509, Artesian Water Company to the Pacific Mutual Life Insurance Company of California.....	62
5—Letter dated July 17, 1936 to Pacific Mutual Life Insurance Company of California from William E. Ware.....	80
6—Letter dated September 14, 1936 to Artesian Water Company from Pacific Mutual Life Insurance Company	83

Index	Page
Exhibits for petitioner (continued):	
7—Order authorizing receiver to make payment on principal of note se- cured by mortgage and assignment of leases	89
9—Income tax return of Artesian Water Company for year 1937.....	106
Statement of the Case on Behalf of Peti- tioner	44
Statement of the Case on Behalf of Re- spondent	47
Witnesses for petitioner:	
Ware, William E.	
—direct	48
—cross	96
—redirect	103

APPEARANCES:

For Taxpayer:

GEORGE A. WITTER, Esq.

For Comm'r:

E. A. TONJES, Esq.

Docket No. 100842

ARTESIAN WATER COMPANY,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

DOCKET ENTRIES

1939

Dec. 12—Petition received and filed. Taxpayer notified. (Fee paid).

Dec. 12—Copy of petition served on General Counsel.

1940

Jan. 23—Answer filed by General Counsel.

Jan. 23—Request for circuit hearing Los Angeles, Calif., filed by General Counsel.

Jan. 25—Notice issued placing proceeding on Los Angeles, Calendar. Answer and request served.

Apr. 5—Motion to place on Circuit Calendar for hearing in Los Angeles, California in June, 1940, filed by taxpayer.

1940

Apr. 11—Hearing set June 3, 1940, in Los Angeles, California.

June 11—Hearing had before Mr. Black on merits. Submitted. Amended petition and answer to amend petition filed. Copies served. Petitioner's brief due July 26, 1940. Respondent's Aug. 26, 1940. Reply Sept. 10, 1940.

July 11—Transcript of hearing of June 11, 1940, filed.

July 22—Brief filed by taxpayer. 7/22/40 copy served on General Counsel.

Aug. 26—Brief filed by General Counsel.

Sept. 5—Motion for extension of 20 days to file reply brief filed by taxpayer. 9/5/40 granted.

Sept. 20—Reply brief filed by taxpayer. 9/20/40 copy served on General Counsel.

1941

Jan. 22—Findings of fact and opinion rendered, Mr. Black, Div. 15. Decision will be entered for the respondent.

Jan. 24—Decision entered, Black, Div. 15.

Apr. 16—Petition for review by United States Circuit Court of Appeals, Ninth Circuit, filed by taxpayer.

Apr. 16—Praeipie filed by taxpayer.

Apr. 17—Proof of service of petition for review filed by taxpayer.

Apr. 17—Proof of service of praecipe filed. [1*]

*Page numbering appearing at foot of page of original certified Transcript of Record.

United States Board of Tax Appeals

Docket No. 100824

ARTESIAN WATER COMPANY,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

PETITION

The above named Petitioner hereby appeals from the determination of the Respondent set forth in his deficiency letter dated September 21, 1939, symbols IT:LA FHG-90D, and as a basis of this proceeding alleges as follows:

I.

Petitioner is a corporation organized and existing under and by virtue of the laws of the State of California with its principal place of business at Los Angeles, California.

II.

The deficiency letter, copy of which is attached hereto and marked Exhibit "A", was mailed to the Petitioner on or about September 21, 1939.

III.

The taxes in controversy are for the calendar year 1937 and amount to the sum of \$7,380.33.

IV.

The determination of taxes set forth in said deficiency letter is based upon the following error:

Respondent erred in imposing a surtax upon the undistributed profits of the Petitioner. [2]

V.

The facts upon which Petitioner relies as a basis for this proceeding are as follows:

The Petitioner was placed in receivership under jurisdiction of the Superior Court of the State of California in and for Los Angeles County in the year 1935 and remained continuously in receivership until finally discharged February 8, 1939. During the entire year 1937 Petitioner was in State Receivership and insolvent.

In 1929 and 1930 the Petitioner borrowed from the Pacific Mutual Life Insurance Company of California a total amount of \$210,000.00, evidenced by four notes, all of which matured on November 12, 1934. These notes were secured by a mortgage on the lands owned by the Petitioner. The Petitioner was unable to make payment on the notes and on November 7, 1934, made application for a renewal or extension. This request was rejected by letter dated November 9, 1934, but time for the payment of the loan was thereafter advanced from quarter to quarter during the year 1935 and the early part of 1936.

In 1936 the Insurance Commissioner of the State of California made a special investigation of the

Pacific Mutual Life Insurance Company of California, as a result of which he severely criticized the loans to this Petitioner. The Commissioner appointed a Conservator for the Insurance Company. The Conservator of the Company made repeated and insistent demands upon the Petitioner, then in receivership, for payment of its loans. The Petitioner was wholly unable to meet such demands. The Petitioner, acting through [3] its Receiver, made efforts to refinance the loan or a portion thereof but without success. On or about September 1, 1936, the Receiver of the Petitioner began making monthly payments to the Conservator. During the year 1937 the Petitioner paid said Conservator the amount of interest due on said notes and approximately \$83,000.00 on principal. On December 31, 1937, the balance owing to said Conservator was \$100,250.00 on account of said notes. The Petitioner's net taxable income for 1937 was \$54,101.14. During all of the year 1937 the lands and leasehold of the Petitioner were assigned to the said insurance company as security for said loans and said leasehold represented 97% of the Petitioner's income .

Wherefore, Petitioner prays that the Board hear and determine this appeal and render judgment in accordance with the foregoing.

GEORGE G. WITTER (Sgd)

Attorney for Petitioner

453 South Spring Street

Los Angeles, California [4]

State of California,
County of Los Angeles—ss.

Howard C. Bonsall, being duly sworn, deposes and says: That he is the President of the Artesian Water Company, the Petitioner named in the foregoing petition, that he is duly authorized to verify the same; that he has read the said petition and is familiar with the statements contained therein and that the facts stated are true as he verily believes.

HOWARD C. BONSTALL (Sgd)

Subscribed and sworn to before me this 6th day of December, 1939.

[Seal] ROLAND FRIESS (Sgd)

Notary Public in and for said County and State.

My Com. expires Nov. 25, 1942. [5]

EXHIBIT "A"

Treasury Department
Internal Revenue Service
12th Floor

U. S. Post Office and Court House
Los Angeles, California

Sep. 21, 1939

Office of
Internal Revenue
Agent in Charge
Los Angeles Division
IT:LA
FHG-90D
Artesian Water Company,
Consolidated Building,
Sixth and Hill Streets,
Los Angeles, California.

Sirs:

You are advised that the determination of your income tax liability for the taxable year 1937 discloses a deficiency of \$7,380.33 as shown in the statement attached.

In accordance with the provisions of existing internal revenue laws, notice is hereby given of the deficiency mentioned.

Within 90 days (not counting Sunday or a legal holiday in the District of Columbia as the 90th day) from the date of the mailing of this letter, you may file a petition with the United States Board of Tax Appeals for a redetermination of the deficiency.

Should you not desire to file a petition, you are requested to execute the enclosed form and forward it to Internal Revenue Agent in Charge, Los Angeles, California, for the attention of IT:LA:FC. The signing and filing of this form will expedite the closing of your return by permitting an early assessment of the deficiency, and will prevent the accumulation of interest, since the interest period terminates 30 days after filing the form, or on the date assessment is made, whichever is earlier.

Respectfully,

GUY T. HELVERING,

Commissioner,

By (Signed) GEORGE D. MARTIN

Internal Revenue Agent in Charge.

Enclosures:

Statement.

Form of Waiver. [6]

FHG-MAH

STATEMENT

IT:LA

FHG-90D

Artesian Water Company,
Consolidated Building,
Sixth and Hill Streets,
Los Angeles, California.

Tax Liability for the Taxable Year Ended
December 31, 1937.

Income Tax Liability—\$14,335.50

Assessed—\$6,955.17

Deficiency—\$7,380.33

In making this determination of your income tax liability, careful consideration has been given to the report of examination dated January 13, 1939; to the protest dated February 7, 1939; to the statements made at the conference held on February 28, 1939; and to Bureau letters dated March 3, 1939 and May 9, 1939.

While your corporation was in receivership during the entire taxable year, such receivership was terminated and the receiver discharged on February 23, 1939; and the assessment of income tax made under the provisions of Section 274 of the Revenue Act of 1936, of which you were advised in Bureau letter dated March 3, 1939, has been abated.

A copy of this letter and statement has been mailed to your representative, Mr. George G. Witter, Citizens National Bank Building, Los Angeles, California, in accordance with the authority contained

in the power of attorney executed by you and on file with the Bureau. [7]

Net Income

Taxable year ended December 31, 1937.

Net income as disclosed by return.....\$54,101.14

No change is made in the net income as reported in the return filed for the taxable year, and the deficiency stated herein is due to the computation of the surtax on undistributed profits imposed by Section 14 of the Revenue Act of 1936, for which no computation was included in the return.

The contention made, in both the return and the protest, that the corporation was not liable in the taxable year for the surtax imposed by the said Section 14, is denied for the reason that the evidence presented fails to show that you came within the purview of the exemption granted by Section 14 (d) (2).

In computing the surtax only the amount of \$8,250.00 paid on relevant indebtedness is allowed as a credit for contracts restricting dividend payments, under the provisions of Section 26(c)(1) of the Revenue Act of 1936, for the reason that the information presented fails to substantiate that a greater credit is allowable. [8]

COMPUTATION OF TAX

Taxable year ended December 31, 1937

NORMAL INCOME TAX

Taxable net income.....	\$54,101.14
Less: Excess-profits tax.....	None
<hr/>	
Normal—tax net income.....	\$54,101.14
Normal tax:	
8% of \$ 2,000.00.....	\$ 160.00
11% of 13,000.00.....	1,430.00
13% of 25,000.00.....	3,250.00
15% of 14,101.14.....	2,115.17
<hr/>	
Total normal tax.....	\$6,955.17

SURTAX ON UNDISTRIBUTED PROFITS

Taxable net income.....	\$54,101.14
Less: Normal tax.....	6,955.17
<hr/>	
Adjusted net income.....	\$47,145.97
Less: Credit for contracts restricting dividend payments.....	8,250.00
<hr/>	
Undistributed net income.....	\$38,895.97
Surtax:	
7% of \$ 5,000.00.....	\$ 350.00
12% of 4,714.60.....	565.75
17% of 9,429.20.....	1,602.96
22% of 9,429.19.....	2,074.42
27% of 10,322.98.....	2,787.20
<hr/>	
Total surtax	\$ 7,380.33
Normal tax	6,955.17
<hr/>	
Total income tax (normal tax and surtax).....	\$14,335.50

Income tax assessed (normal tax and surtax):

Original list, account No. 402482.....\$6,955.17

Additional, page 0, line 0, Commis-
sioner's #2 list, March 10, 1939

(Sec. 274)\$7,380.33

Less: Abatement allowed

July 28, 1939..... 7,380.33 0.00

Net amount assessed..... 6,955.17

Deficiency of income tax..... \$ 7,380.33

[Endorsed]: U. S. B. T. A. Filed Dec. 12, 1939.

[9]

[Title of Board and Cause.]

ANSWER

The Commissioner of Internal Revenue, by his attorney, J. P. Wenchel, Chief Counsel, Bureau of Internal Revenue, for answer to the petition of the above-named taxpayer, admits and denies as follows:

I and II. Admits the allegations contained in paragraphs I and II of the petition.

III. Admits that the taxes in controversy are for the calendar year 1937; denies the remainder of the allegations contained in paragraph III of the petition.

IV. Denies the allegations of error contained in paragraph IV of the petition.

V. Denies the allegations of fact contained in paragraph V of the petition.

VI. Denies each and every allegation contained in the petition not hereinbefore specifically admitted or denied [10]

Wherefore, it is prayed that the determination of the Commissioner be approved.

(Signed) J. P. WENCHEL

FTH

Chief Counsel,

Bureau of Internal Revenue

Of Counsel:

ALVA C. BAIRD,

FRANK T. HORNER,

E. A. TONJES,

Special Attorneys,

Bureau of Internal Revenue.

EAT/mm 1/15/40

[Endorsed]: U. S. B. T. A. Filed Jan. 23, 1940.

[11]

[Title of Board and Cause.]

AMENDED PETITION

The above named Petitioner hereby appeals from the determination of the Respondent set forth in his deficiency letter dated September 21, 1939, symbols IT:LA FHG-90D, and as a basis of this proceeding alleges as follows:

I.

Petitioner is a corporation organized and existing under and by virtue of the laws of the State of California with its principal place of business at Los Angeles, California.

II.

The deficiency letter, copy of which is attached hereto and marked Exhibit "A", was mailed to the Petitioner on or about September 21, 1939.

III.

The taxes in controversy are for the calendar year 1937 and amount to the sum of \$7,380.33.

IV.

The determination of taxes set forth in said deficiency letter is based upon the following error:

Respondent erred in imposing a surtax upon the undistributed profits of the Petitioner. [12]

V.

The facts upon which Petitioner relies as a basis for this proceeding are as follows:

The Petitioner was placed in receivership under jurisdiction of the Superior Court of the State of California in and for Los Angeles County in the year 1935 and remained continuously in receivership until finally discharged February 8, 1939. During the entire year 1937 Petitioner was in State Receivership and insolvent.

In 1929 and 1930 the Petitioner borrowed from the Pacific Mutual Life Insurance Company of

California a total amount of \$210,000.00, evidenced by four notes, all of which matured on November 12, 1934. These notes were secured by a mortgage on the lands owned by the Petitioner. The Petitioner was unable to make payment on the notes and on November 7, 1934, made application for a renewal or extension. This request was rejected by letter dated November 9, 1934, but time for the payment of the loan was thereafter advanced from quarter to quarter during the year 1935 and the early part of 1936.

In 1936 the Insurance Commissioner of the State of California made a special investigation of the Pacific Mutual Life Insurance Company of California, as a result of which he severely criticized the loans to this Petitioner. The Commissioner appointed a Conservator for the Insurance Company. The Conservator of the Company made repeated and insistent demands upon the Petitioner, then in receivership, for payment of its loans. The Petitioner was wholly unable to meet such demands. The Petitioner, acting through its Receiver, made efforts to refinance the loan or a [13] portion thereof but without success. On or about September 1, 1936, the Receiver of the Petitioner began making monthly payments to the Conservator. During the year 1937 the Petitioner paid said Conservator the amount of interest due on said notes and approximately \$83,000.00 on principal. On December 31, 1937, the balance owing to said Conservator was \$100,250.00 on account of said notes. The Petition-

er's net taxable income for 1937 was \$54,101.14. During all of the year 1937 the lands and leasehold of the Petitioner were assigned to the said insurance company as security for said loans and said leasehold represented 97% of the Petitioner's income.

On January 1, 1937, the Petitioner, then in receivership still, owed on account of notes which had matured more than two years before, the principal sum of \$183,250.00. It had an operating deficit on January 1, 1937, of \$50,571.97. On December 31, 1937, it still owed on account of said notes the principal sum of \$100,250.00 and had an earned surplus of \$34,442.50. Said deficit and earned surplus as stated, however, was determined without any deduction for depletion. If depletion were applied, there would still be a deficit at the close of the year 1937.

The following quoted sections are taken from the Civil Code of the State of California, and were in full force and effect during all the period mentioned in this petition.

“§346. Cash or Property Dividends. A corporation may declare dividends payable in cash or in property only as follows:

“(1) Out of earned surplus; or

“(2) Despite the fact that the net assets of the corporation amount to less than the stated capital, [14] out of net profits earned during the preceding accounting period which shall not be less than six months nor more than one year in duration; or

* * * * *

“Dividends: No dividends shall be declared when there is reasonable ground for believing that thereupon the corporation’s debts and liabilities would exceed its assets or that it would be unable to meet its debts and liabilities as they mature.

* * * * *

“Wasting Asset Corporation. A wasting asset corporation, that is a corporation engaged solely or substantially in the exploitation of mines, oil wells, gas wells, patents or other wasting assets, or organized solely or substantially to liquidate specific assets, may distribute the net income derived from the exploitation of such wasting assets or the net proceeds derived from such liquidation without making any deduction or allowance for the depletion of such assets incidental to the lapse of time, consumption, liquidation or exploitation; subject, however, to adequate provision for meeting debts and liabilities and the liquidation preferences of outstanding shares and to notice to shareholders that no deduction or allowance has been made for such depletion. (Added by Stats. 1931, p. 1803; Amended by Stats. 1933, p. 1384.)

* * * * *

“§363. Unlawful Dividends, Purchases and Distribution. Except as provided in this title, the directors of a corporation shall not authorize or ratify the purchase by it of its shares or declare or pay dividends or authorize or ratify

the withdrawal or distribution of any part of its assets among its shareholders.”

Said Petitioner was wholly unable to make adequate provision for payment of its indebtedness in the year 1937. Its net taxable income was \$54,101.14. It actually paid \$83,000.00 on its indebtedness in 1937. It still owed \$100,250.00 at the end of the year 1937, which indebtedness at that time was over three years in default and bearing interest at the rate of [15] Seven Per Cent. Had the Petitioner applied its total gross receipts to payment of said indebtedness in 1937 it still would not have made adequate provision for payment of indebtedness.

Said Petitioner was prohibited under said laws from declaring any dividends during 1937. Said laws are a part of the Petitioner's charter and constituted a contract restricting the declaration of any dividends during 1937.

To secure said notes the Petitioner had assigned in writing all rents and royalties from its lands to the owner and holder of said notes and said assignment constituted a contract restricting its declaration of dividends throughout the year 1937.

Wherefore, Petitioner prays that the Board hear and determine this appeal and render judgment in accordance with the foregoing.

GEORGE G. WITTER (Sgd)

Attorney for Petitioner

453 South Spring Street
Los Angeles, California.

[16]

State of California,
County of Los Angeles—ss.

Howard C. Bonsall, being duly sworn, deposes and says: That he is the President of the Artesian Water Company, the Petitioner named in the foregoing Amended Petition, that he is duly authorized to verify the same; that he has read the said Amended Petition and is familiar with the statements contained therein and that the facts stated are true as he verily believes.

HOWARD C. BONSTALL (Sgd)

Subscribed and sworn to before me this 4th day of June, 1940.

[Seal] ROLAND FRIESS (Sgd)

Notary Public in and for said County and State.

For Exhibit "A" see Exhibit "A" attached to petition.

[Endorsed]: U.S.B.T.A. Filed at hearing Jun. 11, 1940. [17]

[Title of Board and Cause.]

ANSWER TO AMENDED PETITION

The Commissioner of Internal Revenue, by his attorney, J. P. Wenchel, Chief Counsel, Bureau of Internal Revenue, for answer to the amended petition of the above-named taxpayer, admits and denies as follows:

I and II. Admits the allegations contained in paragraphs I and II of the amended petition.

III. Admits that the taxes in controversy are for the calendar year 1937; denies the remainder of the allegations contained in paragraph III of the amended petition.

IV. Denies the allegations of error contained in paragraph IV of the amended petition.

V. Denies the allegations of fact contained in paragraph V of the amended petition.

VI. Denies each and every allegation contained in the amended petition not hereinbefore specifically admitted or denied. [18]

Wherefore, it is prayed that the determination of the Commissioner be approved.

J. P. WENCHEL,

Chief Counsel,

Bureau of Internal Revenue.

Of Counsel:

ALVA C. BAIRD,

FRANK T. HORNER,

E. A. TONJES,

Special Attorneys,

Bureau of Internal Revenue.

EAT/mm 6/4/40.

[Endorsed]: U.S.B.T.A. Filed Jun. 11, 1940. [19]

[Title of Board and Cause.]

Docket No. 100824. Promulgated January 22,
1941.

1. Petitioner during the taxable year was in the hands of a receiver but was not insolvent. The receivership had not been instituted by the corporation's creditors but by a dissatisfied stockholder. Petitioner had assets which considerably exceeded its liabilities and during the taxable year had a net income of \$54,101.14 and paid to its principal creditor very substantial payments on its indebtedness. Held, that petitioner is not exempt from the undistributed profits surtax as an insolvent corporation in receivership, under the provisions of section 14 (d) (2), Revenue Act of 1936.

2. Petitioner in the beginning of the taxable year had a deficit, but with its earnings, in the taxable year that deficit was wiped out and at the end of the year it had an earned surplus. Held, that the applicable code of California, which prevented petitioner from declaring any dividend so long as it had a deficit, is not a contract restricting the payment of dividends within the meaning of section 26 (c) (1), Revenue Act of 1936. *Helvering v. Northwest Steel Rolling Mills, Inc.*, U. S.

3. Petitioner, to secure its indebtedness to an insurance company which was its principal creditor, several years prior to the taxable

year gave a mortgage on two farms which it owned, and as additional security it assigned certain oil royalties which it was to receive under the terms of an oil lease. These oil royalties were to be paid to petitioner and not to the creditor. Held, there is nothing shown in the assignments of these oil royalties as additional security which expressly restricted petitioner in the payment of dividends within the meaning of section 26 (c) (1), Revenue Act of 1936.

George G. Witter, Esq., for the petitioner.

E. A. Tonjes, Esq., for the respondent.

The Commissioner has determined a deficiency of \$7,380.33 in petitioner's surtax liability for the year ended December 31, 1937. The Commissioner in his deficiency notice, in explanation of his determination of the deficiency, stated as follows:

No change is made in the net income as reported in the return filed for the taxable year, and the deficiency stated herein is due to the computation of the surtax on undistributed profits imposed by Section 14 of the Revenue Act of 1936, for which no computation was included in the return.

The contention made, in both the return and the protest, that the corporation was not liable in the taxable year for the surtax imposed by the said Section 14, [20] is denied for the reason that the evidence presented fails to show

that you came within the purview of the exemption granted by Section 14 (d) (2).

In computing the surtax only the amount of \$8,250.00 paid on relevant indebtedness is allowed as a credit for contracts restricting dividend payments, under the provisions of Section 26 (c) (1) of the Revenue Act of 1936, for the reason that the information presented fails to substantiate that a greater credit is allowable.

To this action of the Commissioner imposing a surtax upon the undistributed profits of petitioner for the year 1937, the petitioner has assigned error. That assignment of error has been denied by the Commissioner and this presents the only issue for our decision.

FINDINGS OF FACT.

The petitioner is a California corporation, with principal place of business in the city of Los Angeles in said state.

Prior to and during the taxable year the petitioner owned certain assets which are described in part only in our record. Specifically two parcels of farm lands are legally described in a mortgage dated November 12, 1929, which is in evidence. Certain other properties, namely, the Shell Oil lease, the Home Villa Tract (a subdivision), and the Asphalt Paving Co. lease are referred to by names only in the evidence. From the income producing standpoint the Shell Oil lease, which yielded

more than 90 percent of all of petitioner's income during the taxable year, was the most valuable of all of these properties.

On November 12, 1929, the petitioner refinanced a loan owing by it to the Pacific Mutual Life Insurance Co., a corporation, hereinafter called the insurance company, by delivering to the latter two promissory notes, for \$175,000 and \$35,000, respectively, due five years after date and bearing interest at the rate of 6 percent per annum. To secure payment of these notes the petitioner executed in favor of the insurance company the mortgage hereinbefore mentioned covering its two parcels of farm lands described therein. In connection with the loan of \$175,000 the petitioner assigned a lease in which the Shell Oil Co. was lessee as a further security for the payment of the note. In accordance with the terms of the agreement the Shell Oil Co. continued to pay all royalties to the petitioner. This practice was continued through the entire year 1937. There is no evidence in the record indicating that there was any contract in writing wherein the petitioner agreed not to pay any dividends during the period it was obligated under the \$175,000 loan.

In addition to the mortgage and assignments so executed to secure payment of the said notes, a separate agreement was made respecting the \$35,000 note to the effect that the petitioner would refrain from declaring any dividends upon its capital stock

so long as said [21] note remained unpaid. The Commissioner has allowed a credit in computing petitioner's undistributed profits tax for the amount paid by petitioner on this \$35,000 note during the year 1937.

On July 16, 1935, William E. Ware was appointed receiver for the petitioner. The appointment of Ware as receiver arose out of an action by one J. Baldwin against Frederick Ringe, who was a stockholder of the petitioner. Baldwin had a judgment against Ringe in an amount approximating \$200,000, which apparently could not be satisfied. After considerable investigation Baldwin located a safe deposit box used by Ringe which contained some of the capital stock of the Artesian Water Co., the petitioner. The stock was acquired by Baldwin under a sheriff's sale and in due course application was made to have the stock thus acquired by Baldwin transferred to him on the corporate records. The corporate officers refused to transfer the stock to Baldwin, whereupon he petitioned the Superior Court for the appointment of a receiver, on the ground that the corporate officers were not functioning under the code, which action resulted in the appointment of Ware as receiver. The receivership proceeding was not brought, nor was it continued, by reason of the inability of the corporation to pay its debts. Petitioner had substantially no debts except the amounts which it owed to the Pacific Mutual Life Insurance Co. This latter company had no part in the appointment of

the receiver, nor did it at any time press for the continuance of the receivership. The following is the order entered by the court upon the appointment of the receiver:

It is hereby ordered that until further order of this Court William E. Ware, is named and appointed receiver of the Artesian Water Company, a corporation.

That the receiver has, under the control of this court, power to bring and defend actions in his own name as receiver; to take, manage, operate and keep possession of the property, both real and personal, and each and all of it; to receive rents; collect debts; to compound for and compromise the same; and, subject to order of Court, to make transfers. The receiver is authorized to take possession of all books, records, correspondence and accounts of the said Artesian Water Company.

Said receiver, subject to the Order of this court, shall have the full power and authority to operate the business of the Artesian Water Company in each and all of its departments, and in its entirety.

The receiver took over petitioner's properties on the above date and immediately began negotiations with the insurance company for an extension or renewal of the loans above described. While these negotiations were pending, a conservator was appointed for the insurance company by the State

Insurance Commissioner of California. There is nothing in the record to show that the appointment of the conservator by the insurance commissioner had anything to do with [22] the indebtedness of petitioner. After the conservator for the insurance company took charge, he disapproved said loans to petitioner on account of an interlocking relationship between the two corporations and refused any further extension of time for their payment. The receiver then attempted to refinance the loans through brokers but was unsuccessful owing to questions raised over his legal authority to pledge the intrusted assets.

In the situation, the insurance company consented to "informally" allow the petitioner until March 2, 1937, to refinance the loans, conditioned upon certain payments being made during the ensuing period. The petitioner paid \$25,000 upon the notes during the year 1936 and made additional payments during 1937 which reduced the joint balance on the notes to \$100,250. The petitioner owed no debts, other than current obligations, which were paid when due, at any time here shown, except its said debts to the insurance company, and was at all times here material a solvent corporation.

OPINION.

Black: The petitioner in its return for the taxable year reported gross income of \$171,493.42, from which it claimed deductions amounting to \$119,805.17, leaving a taxable net income of \$54,101.14,

upon which it paid the normal income tax for the year.

The petitioner paid no surtax upon its undistributed profits for the year but in its return claimed an exemption from that obligation. It stated its claim for exemption as follows:

Exemption from undistributed profits surtax is claimed on the following grounds: Attention is respectfully directed to Section 14 of the Revenue Act of 1936, part (d) (2) of which reads:

(d) Exempt from surtax. The following corporations shall not be subject to the surtax imposed by this Section:

(2) Domestic corporations which for any portion of the taxable year are in bankruptcy under the laws of the United States, or are insolvent and in receivership in any Court of the United States, or of any State, Territory, or the District of Columbia.

The word "insolvent" was apparently used in its dual sense by Congress. The Senate Finance Committee Report on the Revenue Bill of 1936 of June 1, 1936, on page 15, in discussing Section 14 (d) (2), said:

The Finance Committee Bill also avoids the possibility of tax avoidance by collusive receiverships by limiting the provision to cases in which the corporation is in bankruptcy under the Federal bankruptcy laws, and to cases in which it is insolvent, i. e., its lia-

bilities are in excess of its assets or it is unable to pay the claims of creditors as they mature—and in receivership in Federal or State Courts.

The taxpayer was certainly unable to pay the claims of its creditors as they matured. That is, it was unable to pay them in the usual course of business out [23] of quick assets without selling its capital assets. 32 Corpus Juris 806 states that the word “insolvency” has two meanings:

In its general and popular meaning, the term denotes the state of one whose entire property and assets, when converted into money without unreasonable haste or sacrifice, are insufficient to pay his debts: But it is frequently used in the more restricted sense to express the inability of a person to pay his debts as they become due in the ordinary course of business.

Creditors claims, referred to above, which the corporation was unable to pay at maturity, consist of balance due the Pacific Mutual Life Insurance Company on account of money borrowed on November 12, 1929, and represented by two notes, one for \$35,000 and one for \$175,000. The note for \$35,000 carried with it a specific agreement prohibiting the payment of dividends until said note was paid. During 1936 the sum of \$26,750 was paid on this note leaving a balance of \$8,250 which balance was paid

during 1937, whereupon the note and collateral agreement were cancelled.

Similarly, during 1937 payments totaling \$74,750 were made on the note for \$175,000, making a grand total of payments made of \$83,000.

The corporation owns subdivision land and oil producing property. The oil land is under lease to Shell Oil Company. The corporation secured its note to the Pacific Mutual Life Insurance Company by a mortgage on its properties, and gave as collateral security an assignment of the oil lease "together with all rents due, or to become due thereunder." The mortgagee notified Shell Oil Co. of the pledge of the lease and rents and instructed Shell Oil Co. to continue to pay the rents and royalties due under the lease to the corporation until further notice. The note and mortgage became due November 30, 1934, and is still past due. It has not been extended or renewed, and will outlaw November 30, 1938.

The corporation has never been in a position to pay off the mortgage out of current assets. From the foregoing, it is apparent, therefore, the corporation was insolvent and in receivership during the taxable year 1937, and is exempt from the surtax under Section 14.

The respondent in his audit disallowed petitioner's claim for exemption as an insolvent corporation, but, in recognition of its agreement not to

declare dividends so long as the \$35,000 note remained unpaid, allowed it a credit from the adjusted base in amount of \$8,250, under authority of section 26 (c) (1) of the Revenue Act of 1936.¹

Petitioner, in its brief, states that the points which it relies upon are as follows:

1. The petitioner was in receivership and insolvent in the taxable year.

2. The California codes prohibited the declaration of dividends by the petitioner during the taxable year. [24]

We shall take these points up in their order. As to point 1, it is clear that petitioner was in receivership, but it is also equally clear that this receivership was not occasioned by any insolvency of petitioner. It was due to an altogether different cause.

¹Sec. 26. Credits of Corporations.

* * * * *

(c) Contracts Restricting Payment of Dividends.—

(1) Prohibition on Payment of Dividends.—An amount equal to the excess of the adjusted net income over the aggregate of the amounts which can be distributed within the taxable year as dividends without violating a provision of a written contract executed by the corporation prior to May 1, 1936, which provision expressly deals with the payment of dividends. If a corporation would be entitled to a credit under this paragraph because of a contract provision and also to one or more credits because of other contract provisions, only the largest of such credits shall be allowed, and for such purpose if two or more credits are equal in amount only one shall be taken into account.

Petitioner concedes that the receivership was not instituted by its creditor, the insurance company, nor was it prolonged by any insistence on the part of the insurance company. Petitioner does contend, however, that in the taxable year 1937 it was insolvent within the meaning of the applicable statute, and that, when the two conditions exist simultaneously, namely, insolvency and receivership, then the exemption provided by section 14 (d) (2) applies. Petitioner, in support of its contention that it was insolvent during the taxable year within the meaning of the act, quotes from *Dutcher v. Wright*, 94 U. S. 553:

Insolvency, in the sense of the Bankrupt Act, means that the party whose business affairs are in question is unable to pay his debts as they become due, in the ordinary course of his daily transactions; and a creditor may be said to have reasonable cause to believe his debtor to be insolvent when such a state of facts is brought to his notice respecting the affairs and pecuniary condition of his debtor as would lead a prudent man to the conclusion that the debtor is unable to meet his obligations as they mature, in the ordinary course of his business. *Buchanan v. Smith*, 16 Wal., 308, 21 L. Ed., 286; *Toof v. Martin*, 13 Wal. 1, 40, 20 L. Ed., 481. * * *

That the word "insolvent" as used in section 14 (d) (2) was intended by Congress to carry the meaning used in the above language by the Supreme

Court, petitioner contends is evidenced by Senate Finance Committee Report of June 1, 1936, on the Revenue Bill of 1936, where on page 15, in discussing section 14 (d) (2), it is said:

The Finance Committee Bill also avoids the possibility of tax avoidance by collusive Receiverships by limiting the provision to cases in which the corporation is in bankruptcy under the Federal bankruptcy laws, and to cases in which it is insolvent, i. e., its liabilities are in excess of its assets or it is unable to pay the claims of creditors as they mature—and in receivership in Federal or State Courts.

We accept as correct the contention which petitioner makes as to the meaning of the word “insolvent” as used in section 14 (d) (2). We do not think, however, that the evidence shows that petitioner was “insolvent” within the meaning of the act and the foregoing definition at any time during the taxable year. In a balance sheet attached to its income tax return for the taxable year, its total assets are listed at a value of \$1,162,789.84; its total liabilities, exclusive of capital stock and surplus, are listed at \$144,255.21. It had net income in 1937 of \$54,101.14.

While it did not finish paying all of its indebtedness to the insurance company in 1937, it paid \$83,000 of it in that year and, as has already been stated, this creditor had nothing whatever to do with [25] instituting the receivership and took no

part in prolonging it. Under these circumstances we can not hold that petitioner was an insolvent corporation in receivership during the taxable year. It was not exempt under section 14 (d) (2). On this point we sustain respondent.

As to point 2, raised in petitioner's brief, it is equally clear that the respondent must prevail. The question of whether or not state laws and/or charter provisions of a corporation create contractual relations recognizable in determining Federal income tax questions has been the subject of diverse decisions in different courts, notably in *Northwest Steel Rolling Mills, Inc. v. Commissioner*, 110 Fed. (2d) 286, where the Circuit Court of Appeals for the Ninth Circuit sustained the position herein contended for by the petitioner; and in *Crane Johnson Co. v. Commissioner*, 105 Fed. (2d) 740, wherein the Circuit Court of Appeals for the Eighth Circuit held to the opposite view. To settle this conflict in Circuit Court opinions, the Supreme Court granted certiorari in both cases (309 U. S. 692; 311 U. S. —) and rendered its decision sustaining the Eighth Circuit Court's views in *Crane Johnson Co. v. Commissioner*, — U. S. —, and reversing the Ninth Circuit Court's decision in *Helvering v. Northeast Steel Rolling Mills, Inc.*, — U. S. — (Nov. 12, 1940). Following the Supreme Court's decision in these two cases we sustain respondent as to point 2.

We have disposed of the two points raised by petitioner in its original brief. The petitioner, in its reply brief, has raised a third point which in sub-

stance is this: Petitioner had assigned prior to May 1, 1936, as additional security for the payment of its \$175,000 note due the insurance company, the oil royalties which it was to receive from the Shell Oil Co., and while this assignment did not expressly limit petitioner in the payment of dividends so long as any of the \$175,000 note remained unpaid, nevertheless there was an implied restriction on the payment of dividends imposed by the agreement, and petitioner is entitled thereby to a credit under section 26 (c) (1), *supra*.

There is nothing to show that the assignment of the Shell Co. oil royalties by petitioner to its creditor, the Pacific Mutual Insurance Co., as further security for the payment of its \$175,000 note, in any manner expressly restricted petitioner in the payment of dividends. This assignment is not in evidence and we do not know what written provisions it contained, but the witness who testified in regard to it did not say that the assignment dealt "expressly with the payment of dividends." Petitioner does not so contend in its brief. It simply contends that because petitioner had assigned these oil royalties to its creditor, as additional security for the payment of its notes, it [26] was by necessary implication prohibited from the payment of any dividends during the effective period of the assignment. We think this contention must be denied. Cf. *Belle-vue Manufacturing Co.*, 43 B. T. A. — (Dec. 6, 1940).

Petitioner does not make any claim that it is en-

titled to a credit under the provisions of section 26 (c) (2). On account, however, of the close connection between paragraphs (1) and (2) of section 26 (c) of the Revenue Act of 1936, perhaps we should say a word as to the applicability of section 26 (c) (2) to the facts of the instant case. We have considered the evidence carefully and we find no contract in evidence which would seem to fall within the provisions of section 26 (c) (2).

Our decision in *G. B. R. Oil Corporation*, 40 B. T. A. 738, which was under section 26 (c) (2), is not applicable to the facts in the instant case. In that case the taxpayer, to secure the loans with which to purchase certain oil leases and oil royalties, executed and delivered to the bank from which it was borrowing the money appropriate deeds of trust and also by separate instruments in writing assigned its interests in the properties to the bank in trust and authorized the bank to receive and collect all sums of money derived from the properties and to apply same on its indebtedness to the bank. Under those circumstances, we held that the taxpayer in computing its adjusted net income was entitled to a credit under section 26 (c) (2) of the amount paid on its indebtedness during the taxable year in compliance with the contract.

In the instant case, there was no requirement that the oil royalties received from the Shell Co. should be paid to petitioner's creditor, the insurance company, as there was in *G. B. R. Oil Corporation*, *supra*. On the contrary, the oil royalties were

to be paid to petitioner and were in fact paid to it. The insurance company had a mortgage on these oil royalty receipts, it is true, and it is undoubtedly true that a considerable portion of them was used as payments on petitioner's indebtedness to the insurance company, but it seems to us that this falls short of meeting the requirements of section 26 (c) (2). Cf. *Nocona Cotton Seed Oil Co.*, 42 B. T. A. 1172.

For reasons above stated we think the facts in the instant case are distinguishable from those which were present in *G. B. R. Oil Corporation*, *supra*.

Decision will be entered for respondent. [27]

United States Board of Tax Appeals
Washington

Docket No. 100824

ARTESIAN WATER COMPANY,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

DECISION

Pursuant to the determination of the Board, as set forth in its Findings of Fact and Opinion, promulgated January 22, 1941, it is

Ordered and decided: That there is a deficiency of \$7,380.33 in surtax liability for the year 1937.

Enter:

Entered Jan. 24, 1941.

[Seal] (Signed) EUGENE BLACK

Member [28]

In the United States Circuit Court of Appeals
for the Ninth Circuit

[Title of Cause.]

PETITION FOR REVIEW

To the Honorable the Judges of the United States
Circuit Court of Appeals for the Ninth Cir-
cuit:

Artesian Water Company, a California corpora-
tion, with its principal place of business at Los
Angeles, California, in support of its petition filed
in pursuance of the provisions of Section 1001 of
the Revenue Act of 1926, for the review of the deci-
sion of the United States Board of Tax Appeals
rendered on January 22, 1941, approving a defi-
ciency in income and undistributed profits taxes of
the Artesian Water Company for the year ended
December 31, 1937, in the sum of \$7,380.33, respect-
fully shows to this Honorable Court as follows:

I.

Statement of the Nature of the Controversy.

Under date of September 21, 1939, the Commissioner of Internal Revenue mailed to the petitioner a final notice of deficiency in surtax on undistributed profits for the year 1937 [29] in the amount of \$7380.33. Within 90 days from the date of said letter the petitioner filed its appeal with the United States Board of Tax Appeals. On the 11th day of June, 1940, a hearing of said appeal was had before a member of the United States Board of Tax Appeals, sitting at Los Angeles. Oral testimony was taken and recorded and documentary evidence introduced. On the 22nd day of January, 1941, the Board handed down its final decision denying the petitioner's contentions.

The petitioner filed its original income tax return for the year 1937, disclosing thereon net income for the year in the amount of \$54,101.14 and an income tax thereon of \$6,955.17, which it paid. When the Commissioner of Internal Revenue audited this return, he determined the net income reported thereon correct and the income tax shown thereon correct, but, further finding that the Company had not distributed this income to its stockholders as dividends, the Commissioner imposed a surtax on undistributed profits based on the rates found in Section 14 of the Revenue Act of 1936. The entire deficiency asserted consists of surtax on undistributed profits and not of income tax.

The taxpayer contended before the Board and now contends that it was not and is not subject to surtax for not distributing its net earnings in the year 1937 for the following reasons.

1. It was in receivership during the entire taxable year 1937 and was unable by any means within its power to pay its debts as they matured and therefore was exempt from such surtax [30] under Section 14(d)(2) of the Revenue Act of 1936.

2. The petitioner had mortgaged all of its income-producing assets to secure indebtedness which it owed and further had assigned its leases and its income to its creditors to secure such indebtedness. Such mortgage and assignment constituted a contract restricting it from the payment of dividends and therefore exempting it from surtax on undistributed profits under Section 26(c) of the Revenue Act of 1936.

3. In the year 1937, the petitioner was unable to pay its debts as they matured and was therefore prohibited under the Statutes of the State of California from the declaration of a dividend, and such statutes constituted a part of its charter and a contract restricting it from the declaration of dividends and rendering it exempt from the surtax on undistributed profits under the provisions of Section 26 of the Revenue Act of 1926.

II.

Designation of Court of Review.

The petitioner being aggrieved by the said decision of the Board of Tax Appeals and having at all

times had its principal place of business in the City of Los Angeles, State of California, and having filed its income tax return for the calendar year 1937 with the Collector of Internal Revenue for the Sixth District of California, desires a review of said decision by the United States Circuit Court of Appeals for the Ninth Circuit. [31]

Wherefore, your petitioner prays that this Honorable Court may review said decision and reverse and set aside the same.

ARTESIAN WATER COMPANY,
a Corporation.

By MARVIN OSBURN,

Assistant Secretary.

GEORGE G. WITTER,

Attorney for Petitioner.

[Endorsed]: U. S. B. T. A. Filed April 16, 1941.

[32]

In the United States Circuit Court of Appeals
for the Ninth Circuit

[Title of Cause.]

NOTICE

To the General Counsel, Bureau of Internal Revenue,
Attorney for Respondent:

You are hereby notified that on the 16 day of April, 1941, a Petition for Review of the decision of the United States Board of Tax Appeals in the above-entitled cause was filed with the Clerk of the

Board, and a true copy of said Petition is herewith served upon you.

(s) GEORGE G. WITTER

Attorney for Petitioner

Receipt of a true copy of Petition for Review so filed is acknowledged this 17th day of April, 1941.

J. P. WENCHEL,

Chief Counsel,

Bureau of Internal Revenue,

Attorney for Respondent.

[Endorsed]: U. S. B. T. A. Filed Apr. 17, 1941.

[33]

Official Report of Proceedings

before the

U. S. Board of Tax Appeals

Docket No. 100842

ARTESIAN WATER COMPANY,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

Hearing at Los Angeles, California

Date June 11, 1940

Pages 1-40

[34]

[Title of Board and Cause.]

REPORTER'S MINUTES

Hearing at Los Angeles on the 11th day of June,
1940, at 10:15 o'clock, A. M.

The above-entitled proceeding came on for hearing on this the 11th day of June, 1940, before the Honorable Eugene Black, Member of the United States Board of Tax Appeals, at Los Angeles, California, pursuant to notice of hearing heretofore given; whereupon, the following proceedings were had and testimony heard, to-wit:

Appearances:

George G. Witter, Esq., (453 South Spring Street, Los Angeles, California), appearing on behalf of Petitioner.

E. A. Tonjes, Esq., (Honorable J. P. Wenchel, Chief Counsel, Bureau of Internal Revenue), appearing on behalf of the Commissioner of Internal Revenue, Respondent. [36]

PROCEEDINGS

The Clerk: Docket No. 100842, Artesian Water Company.

Appearing for the petitioner, George G. Witter.

And your address, Mr. Witter?

Mr. Witter: 453 South Spring Street, Los Angeles, California.

The Clerk: Mr. E. A. Tonjes, for the respondent.

Mr. Tonjes: That is correct, Mr. Clerk.

Mr. Witter: May it please the Board, Your Honor made an order from the bench granting leave to file an amended petition.

Mr. Tonjes: Respondent of course has no objection to that, Your Honor.

Mr. Witter: At this time I would like to file an amended petition.

The Member: The amended petition will be received and filed.

Mr. Tonjes: At this time I would like to have the privilege of filing an answer to the amended petition.

The Member: The answer will be received and filed.

Does the petitioner have any statement to make with reference to the issues involved in this case?

[37]

Statement of Case on Behalf of Petitioner:

By Mr. Witter:

Mr. Witter: I should like to make a brief statement of the issues involved. Also, a very brief digest of the brief that is going to be offered.

The year involved here is the year 1937. The company, the Artesian Water Company, was a company that was organized in California in 1900. It was the owner of lands. In the year 1935 it was thrown into receivership and remained in receivership until 1939. So that during the entire taxable year involved here in 1937 the petitioner was put into state receivership.

Now, the tax that has been imposed by the Government is a surtax on undistributed profits, the deficiency amounting to seven thousand three hundred eighty some odd dollars.

The facts giving rise to this issue are briefly as follows: In the year 1929 the Artesian Water Company owed the Pacific Mutual Company an indebtedness that had been incurred long prior thereto, which amounted to a balance of \$175,000. A new note was given in 1929 for that \$175,000. An additional note was given in 1931 for \$35,000, making a total indebtedness of \$210,000.

Both of these notes matured in 1934. Nothing was paid on these notes between the dates they were given and [38] the date in 1934. In 1934 the company requested the insurance company to extend the period for payment and the insurance company refused.

Then the notes ran on without any payment being made thereon, and in 1935 the Artesian Water Company was put into state receivership. It wasn't put into state receivership by the Pacific Mutual Company to whom these notes were owed. Pacific Mutual Company was secured on those notes by mortgages on practically all of the assets—I will say all of the assets of value which the Artesian Water Company owned.

The principal income of the Artesian Water Company constituted royalties from an oil lease, and to secure these notes the Artesian Water Company had not only given a mortgage on all of its land of

value, and the lands comprised all its assets, but it also assigned to the insurance company all of the rents and royalties from the lease.

In the year 1937, the taxable year, the receiver was confronted with this situation: He had been able to pay on the \$210,000 indebtedness up to January 1st approximately \$25,000. So that at the beginning of the taxable year there was due on these loans approximately \$185,000.

In the middle of the year 1936 a conservator was appointed for the Pacific Mutual and very close scrutiny made of all of its accounts. These notes to the Artesian [39] Water Company came under close scrutiny and came in for very severe criticism. The conservator insisted upon a collection being made immediately. The receiver made very strenuous efforts to get extensions of time, and the best that he was able to obtain in the way of an extension was to March 3, 1937, the insurance company calling for certain payments to be made each month, and the full balance to be paid under all circumstances by March 3, 1937.

The receiver was unable to make any payment of these notes in full or to liquidate either on March 3, 1937 or at any time during 1937. The receiver did what he could in making payments out of whatever income was received and reducing the notes. The Pacific Mutual made no further extension beyond March 3, 1937, but did not bring foreclosure suit.

Eventually, the notes were paid. The receivership

continued until 1939, and then the company emerged from the state receivership.

It is the contention of the taxpayer that it is not subject to undistributed profits tax because it was in state receivership and it was insolvent in the year 1937.

It is further the contention that under the California Codes it had no right to declare any dividends and the directors would have rendered themselves liable if they had done so, and that that would constitute an express [40] contract restricting the payment of dividends.

It is also contended that the assignment of all of the rents and royalties in writing to the note-holding creditor constituted a contract restricting the payment of dividends.

It is also contended that the statutes of this state pertaining to receivership constituted a contract which prevented this company from declaring any dividend during the year 1937.

The Member: All right, Mr. Witter.

Mr. Tonjes, do you have a statement you wish to make?

Statement of Case on Behalf of Respondent:

By Mr. Tonjes:

Mr. Tonjes: Yes.

If Your Honor please, respondent's position is that not only does the statute require that a corporation in order to be exempt from the surtax in question, be exempted, that it must be in receiver-

ship and insolvent, and it is the respondent's contention that the corporation was not insolvent.

That in so far as any restriction is contained in the law of the state of California with respect to the times or the circumstances under which a corporation can make distributions of dividends, do not constitute such a [41] contract in writing as required by the statute in order to be entitled to a dividend paid credit.

The Member: Very well.

We will receive the evidence now, Mr. Witter.

Mr. Witter: I will call Mr. Ware.

Evidence on Behalf of Petitioner:

Thereupon, the petitioner, to maintain the averments of its petition, introduced the following proof:

The Clerk: Give your name to the reporter, please.

Mr. Ware: William E. Ware.

MR. WILLIAM E. WARE,

called as a witness by and on behalf of the petitioner, having been first duly sworn, was examined and testified as follows:

Direct Examination

By Mr. Witter:

Q. Where do you live, Mr. Ware?

A. 174 Westgate Avenue, Brentwood Heights, Los Angeles.

Q. And how long have you lived in Los Angeles?

(Testimony of Mr. William E. Ware.)

A. Oh, thirty years.

Q. And what is your business?

A. Certified Public Accountant.

Q. Were you the receiver for the Artesian Water Company, this taxpayer? [42]

A. I was.

Q. How long were you receiver for that company?

A. From July 16, 1935 to February 8, 1939.

Q. And are you generally familiar with the history of that company? A. I am.

Q. Was the company organized in the state of California? A. It was.

Q. And did it always operate in the state of California? A. It did.

Q. What was the general nature of the assets of the company?

A. It consisted principally of real properties, some vacant acreage with oil leases, and some subdivision properties and vacant properties.

Q. Are you familiar with two notes that were outstanding at the time that you were appointed receiver for the Artesian Water Company?

A. Yes.

Mr. Witter: I will ask you, Mr. Clerk, to mark these documents for identification.

The Clerk: They will be marked Petitioner's Exhibits 1, 2, and 3 for identification. [43]

(The said documents so offered were marked Petitioner's Exhibits 1, 2, and 3, for identification.)

(Testimony of Mr. William E. Ware.)

By Mr. Witter:

Q. I hand you what has been marked Petitioner's Exhibit No. 3 and ask you to state what it is.

A. That is a certified copy of the order appointing the receiver, dated July 16, 1935.

Mr. Witter: I offer Petitioner's Exhibit No. 3 in evidence.

Mr. Tonjes: No objection.

The Member: Very well, it will be received as Petitioner's Exhibit No. 3.

(The said document so offered and received in evidence, was marked Petitioner's Exhibit 3, and made a part of this record.)

PETITIONER'S EXHIBIT NO. 3

In the Superior Court of the State of California
in and for the County of Los Angeles.

No. 390338

J. C. BALDWIN,

Plaintiff,

vs.

FREDERICK H. RINDGE, MAY K. RINDGE,
RHODA ADAMSON, MARVIN OSBURN,
EDWARD L. STAEBLER, A. S. COOPER,
HELEN N. RINDGE, P. B. GOWAN, S. N.
WEST, GEORGE F. ARNOLD, M. F. PE-
TERSON, RINDGE COMPANY, a corpora-

(Testimony of Mr. William E. Ware.)

tion, ARTESIAN WATER COMPANY, a corporation, JOHN DOE ONE, JOHN DOE TWO, JOHN DOE THREE, JOHN DOE FOUR, JANE ROE ONE, JANE ROE TWO, JOHN DOE ONE COMPANY, a corporation, JOHN DOE TWO COMPANY, a corporation, JOHN DOE THREE COMPANY, a corporation, and JOHN DOE AND RICHARD ROE, a co-partnership,

Defendant.

ORDER APPOINTING A RECEIVER.

Upon reading and filing the verified complaint of the plaintiff in the above entitled action, and upon the other papers on file herein, and good cause appearing therefor,—

It Is Hereby Ordered that until further order of this Court William E. Ware, is named and appointed receiver of the Artesian Water Company, a corporation.

That the receiver has, under the control of this court, power to bring and defend actions in his own name as receiver; to take, manage, operate, and keep possession of the property, both real and personal, and each and all of it; to receive rents, collect debts; to compound for and compromise the same; and, subject to order of Court, to make transfers. The receiver is authorized to take possession of all books, records, correspond-

(Testimony of Mr. William E. Ware.)

ence and accounts of the said Artesian Water Company.

Said receiver, subject to the Order of this court, shall have the full power and authority to operate the business of the Artesian Water Company in each and all of its departments, and in its entirety.

[82]

It Is Further Ordered that the defendants, and each and all of them, be and appear in Department 34 of the above entitled Superior Court on the 26th day of July, 1935, at 10 o'clock A. M., to show cause, if any they have, why the appointment of the Receiver herein should not be confirmed.

It Is Hereby Ordered that the plaintiff file an undertaking with sufficient sureties, in the amount of \$1,000.00, conditioned according to law, and the Court does hereby state that said bond so required has been approved by this Court, and filed.

Be It Hereby Further Ordered that the Receiver give and file a bond, on qualifying, with sufficient sureties, in the sum of \$2,000.00, conditioned according to law, and that the said Receiver take the oath required by law. The Court does hereby state that said bond has been furnished by the Receiver, has been approved by this Court, and filed, and, further, that said Receiver has now taken the said oath, as required by law, and as above provided for.

It Is Further Ordered that the said Receiver shall, within ten days after the date of this Order, file with the Court an inventory containing a com-

(Testimony of Mr. William E. Ware.)

plete and detailed list of all property of which he shall take possession by virtue of his appointment, and if he shall thereafter take possession of other property, he shall at once file a supplementary inventory thereof.

Dated: This 16th day of July, 1935.

WILSON

Judge of the Superior Court
of Los Angeles County.

The foregoing instrument is a correct copy of the original on file and/or of record in this office.
(Omitting Points and Authorities) KR

Attest July 16, 1935.

L. E. LAMPTON,

County Clerk and Clerk of
the Superior Court of the
State of California, in and
for the County of Los Angeles.

By K. RANDALL

Deputy

[Endorsed]: Filed Jul 16 1935. L. E. Lampton,
County Clerk, By J. E. Shaw, Deputy.

[Endorsed]: Petitioner's Exhibit No. 3. Admitted in evidence June 11, 1940. [83]

(Testimony of Mr. William E. Ware.)

By Mr. Witter:

Q. I hand you what has been marked Petitioner's Exhibit No. 1 and ask you to state what that is.

A. This is a mortgage note for \$175,000 due to the Pacific Mutual Life Insurance Company of California by the Artesian Water Company, due in five years, with interest at the rate of six per cent per annum.

Mr. Witter: I offer in evidence Petitioner's Exhibit No. 1. [44]

Mr. Tonjes: No objection.

The Member: It will be received as Petitioner's Exhibit No. 1.

(The said document so offered and received in evidence, was marked Petitioner's Exhibit 1, and made a part of this record.)

PETITIONER'S EXHIBIT NO. 1

No. 6509

\$175,000.00

Los Angeles, California, November 12, 1929.

Five years after date, for value received Artesian Water Company, a California Corporation, promises to pay to The Pacific Mutual Life Insurance Company of California, or order, at its office in Los Angeles the sum of One Hundred Seventy-Five Thousand Dollars, with interest from date until paid, at the rate of Six (6) per cent. per annum, payable Quarterly; should the interest not be so paid, it shall become a part of the principal

(Testimony of Mr. William E. Ware.)

and thereafter bear like interest as the principal. Should default be made in the payment of any installment of principal or interest when due, then the whole sum of principal and interest shall become immediately due and payable at the option of the holder of this note. Principal and interest payable in lawful money of the United States. This note is secured by a mortgage upon real property of even date herewith.

[Seal] ARTESIAN WATER COM-
 PANY

By M. K. RINDGE
 President

By A. S. COOPER
 Secretary

[Stamped] Paid 7-25-38 (D) Pacific Mutual Life
Insurance Co. Mortgage Loan Dept.

[Cancelled 7/25/38 R. Nehl]. [76]

(Testimony of Mr. William E. Ware.)

2-11-30	Int. paid.....	\$2,280.38	to	2-12-30
5-13-30	Int. paid.....	\$2,625.00	to	5-13-30
8-12-30	Int. paid.....	\$2,625.00	to	8-12-30
11-12-30	Int. paid.....	\$2,625.00	to	11-12-30
2-16-31	Int. paid.....	\$2,625.00	to	2-12-31
5-19-31	Int. paid.....	\$2,625.00	to	5-12-31
8-12-31	Int. paid.....	\$2,625.00	to	8-12-31
11-12-31	Int. paid.....	\$2,625.00	to	11-12-31
2-13-32	Int. paid.....	\$2,625.00	to	2-12-32
5-17-32	Int. paid.....	\$2,625.00	to	5-12-32
8-16-32	Int. paid.....	\$2,625.00	to	8-12-32
11-12-32	Int. paid.....	\$2,625.	to	11-12-32
2-11-33	Int. paid.....	\$2,625.	to	2-12-33
5-11-33	Int. paid.....	\$2,625.	to	5-12-33
8-16-33	Int. paid.....	\$2,625.	to	8-12-33
11-11-33	Int. paid.....	\$2,625.	to	11-12-33
2-10-34	Int. paid.....	\$2,625.	to	2-12-34
5-14-34	Int. paid.....	\$2,625.00	to	5-12-34
8-10-34	Int. paid.....	\$2,625.00	to	8-12-34
11- 8-34	Int. paid.....	\$2,625.00	to	11-12-34
2-12-35	Int. paid.....	\$2,625.00	to	2-12-35
5-13-35	Int. paid.....	\$2,625.00	to	5-12-35
8-21-35	Int. paid.....	\$2,625.00	to	8-12-35
11-13-35	Int. paid.....	\$2,625.00	to	11-12-35
2-17-36	Int. paid.....	\$2,625.00	to	2-12-36
5-12-36	Int. paid.....	\$2,625.	to	5-12-36
8-18-36	Int. paid.....	\$2,625.	to	8-12-36
11-13-36	Int. paid.....	\$2,625.	to	11-12-36
2-12-37	Int. paid.....	\$2,625.	to	2-12-37
5-12-37	Int. paid.....	\$2,611.71	to	5-12-37
8-13-37	Int. paid.....	\$2,293.30	to	8-12-37
11-12-37	Int. paid.....	\$1,933.	to	11-12-37
4- 1-37	Paid a/c principal \$ 2,750	Unpaid balance	\$172,250	
5- 3-37	Paid a/c principal \$ 2,750	Unpaid balance	\$169,500	
6- 1-37	Paid a/c principal \$ 2,750	Unpaid balance	\$166,750	
6-14-37	Paid a/c principal \$20,000	Unpaid balance	\$146,750	
7- 1-37	Paid a/c principal \$ 2,750	Unpaid balance	\$144,000	

(Testimony of Mr. William E. Ware.)

8- 2-37	Paid a/c principal \$ 2,750	Unpaid balance \$141,250
8-23-37	Paid a/c principal \$10,000	Unpaid balance \$131,250
9- 1-37	Paid a/c principal \$ 2,750	Unpaid balance \$128,500
10- 4-37	Paid a/c principal \$ 2,750	Unpaid balance \$125,750
11- 3-37	Paid a/c principal \$ 2,750	Unpaid balance \$123,000

[77]

PAYMENTS

Date Paid M. D. Y.	Date Due M. D. Y.	Credited on		Balance Principal Unpaid
		Interest	Principal	
12- 1-37	A/c		2,750	120,250
12-16-37	A/c		20,000	100,250
1- 3-38	A/c		2,750	97,500
2- 1-38	A/c		2,750	94,750
2-14-38	2-12-38	1,602.88		
2-23-38	A/c		30,000	64,750
3- 2-38	A/c		2,750	62,000
4- 4-38	A/c		2,750	59,250
4-29-38	A/c		25,000	34,250
5- 2-38	A/c		2,750	31,500
5-11-38	5-12-38	918		
6- 1-38	A/c		2,750	28,750
6-30-38	A/c		2,750	26,000
7-18-38	A/c		11,590	14,410
7-25-38	In full	333.51	14,410	0

[Endorsed]: Petitioner's Exhibit One. Admitted in evidence June 11, 1940. [79]

(Testimony of Mr. William E. Ware.)

By Mr. Witter:

Q. Mr. Ware, this note for \$175,000, marked Petitioner's Exhibit 1, do you know the history of that up to the date that it was given?

A. I think so.

Q. State briefly what the history was.

A. This represents a mortgage note which was given on November 12, 1929, secured by two parcels in Los Angeles County, two parcels of real estate in Los Angeles County, described as Parcel No. 1, being three hundred thirty acres of farm land located between Culver City and Inglewood, which is unimproved; and Parcel 2 representing fifty acres of farm land on six-tenths of a mile east of Washington Street in Culver City, which is also unimproved. It is also secured by the assignment of four leases.

Q. Oil leases?

A. No, not all of them. Some of them are farming leases, and a lease to the Asphalt Paving Company which had a small portion of the land there on which they had a plant [45] located.

Q. Testifying further as to the history of the loan, does it represent refinancing of an earlier debt owed by the company?

A. It does, yes.

Q. Do you recall when the predecessor note was given that this replaced?

A. Well, it represents a series of refinancings. You are going back as far as 1934. But the prin-

(Testimony of Mr. William E. Ware.)

cipal refinancing was in 1924, on which this loan came in.

Q. Does this \$175,000 note represent the unpaid balance of former indebtedness incurred by the Artesian Water Company? A. It does.

Q. I hand you what has been marked for identification Petitioner's Exhibit 2 and ask you to state what that is.

A. This represents a note for \$35,000 dated December 18, 1931, due November 12, 1934, given by the Artesian Water Company to the Pacific Mutual Life Insurance Company of California, with interest at the rate of six per cent per annum.

Mr. Witter: I offer in evidence Petitioner's Exhibit No. 2.

Mr. Tonjes: No objection, Your Honor.

The Member: It will be received as Petitioner's [46] Exhibit No. 2.

(The said document so offered and received in evidence, was marked Petitioner's Exhibit 2, and made a part of this record.)

PETITIONER'S EXHIBIT NO. 2

No. 6509

\$35,000.00

Los Angeles, California, December 18, 1931.

November 12, 1934 after date, for value received Artesian Water Company, a California corporation, promises to pay to The Pacific Mutual Life Insurance Company of California, or order, at its

(Testimony of Mr. William E. Ware.)

office in Los Angeles, the sum of Thirty Five Thousand Dollars, with interest from date until paid, at the rate of Six (6) per cent. per annum, payable February 12, 1932 and Quarterly Thereafter; should the interest not be so paid, it shall become a part of the principal and thereafter bear like interest as the principal. Should default be made in the payment of any installment of principal or interest when due, then the whole sum of principal and interest shall become immediately due and payable at the option of the holder of this note. Principal and interest payable in lawful money of the United States. This note is given for an additional loan as provided by the terms of that certain mortgage dated November 12, 1929, made by undersigned to said The Pacific Mutual Life Insurance Company of California, recorded in Book 9596 of Official Records at page 14, Records of Los Angeles County, State of California, and is secured by all the terms and conditions of said mortgage.

[Seal]

ARTESIAN WATER
COMPANY

By M. K. RINDGE,
President.

By A. S. COOPER,
Secretary.

Paid 3-3-37 [Stamped on face]

Cancelled 3-3-37 [80]

(Testimony of Mr. William E. Ware.)

2-13-32	Int. paid.....	\$245.00	to	2-12-32
5-17-32	Int. paid.....	\$525.	to	5-12-32
8-16-32	Int. paid.....	\$525.	to	8-12-32
11-12-32	Int. paid.....	\$525.	to	11-12-32
2-11-33	Int. paid.....	\$525.	to	2-12-33
5-11-33	Int. paid.....	\$525.	to	5-12-33
8-16-33	Int. paid.....	\$525.	to	8-12-33
11-11-33	Int. paid.....	\$525.	to	11-12-33
2-10-34	Int. paid.....	\$525.	to	2-12-34
5-14-34	Int. paid.....	\$525.	to	5-12-34
8-10-34	Int. paid.....	\$525.	to	8-12-34
11- 8-34	Int. paid.....	\$525.	to	11-12-34
2-12-35	Int. paid.....	\$525.	to	2-12-35
5-13-35	Int. paid.....	\$525.	to	5-12-35
8-21-35	Int. paid.....	\$525.	to	8-12-35
11-13-35	Int. paid.....	\$525.	to	11-12-35
2-17-36	Int. paid.....	\$525.00	to	2-12-36
5-12-36	Int. paid.....	\$525.	to	5-12-36
8-18-36	Int. paid.....	\$525.	to	8-12-36
11-13-36	Int. paid.....	\$497.	to	11-12-36
2-13-37	Int. paid.....	\$110.92	to	2-12-37

11-12-36

As of

11- 5-36	Paid a/c principal	\$24,000	Unpaid balance	\$11,000
12- 1-36	Paid a/c principal	\$2,750	Unpaid balance	\$ 8,250
1- 5-37	Paid a/c principal	\$2,750	Unpaid balance	\$ 5,500
2- 2-37	Paid a/c principal	\$2,750	Unpaid balance	\$ 2,750
3- 3-37	Paid a/c principal	\$2,750	Unpaid balance	\$ 0

[Endorsed]: Petitioner's Exhibit No. 2. Admitted in evidence. June 11, 1940. [81]

(Testimony of Mr. William E. Ware.)

Mr. Witter: I offer in evidence the mortgage that went to secure the two notes that have just been introduced in evidence.

Mr. Tonjes: No objection.

The Member: It will be received as Petitioner's Exhibit No. 4.

(The said document so offered and received in evidence, was marked Petitioner's Exhibit 4, and made a part of this record.)

PETITIONER'S EXHIBIT No. 4

No. 6509

MORTGAGE

Artesian Water Company

to

The Pacific Mutual Life Insurance Company
of California

This Mortgage, Made the twelfth day of November, A. D. nineteen hundred and twenty-nine, by Artesian Water Company, a California Corporation having its principal place of business at Los Angeles, California, Mortgagor, to The Pacific Mutual Life Insurance Company of California, a corporation organized and existing under the laws of the State of California, Mortgagee.

Witnesseth: That the Mortgagor hereby mortgages to the Mortgagee the real property situate in

(Testimony of Mr. William E. Ware.)

the County of Los Angeles, State of California, and described as follows, to-wit:

Parcel #1:

That part of the Rancho Cienega O'Paso de la Tijera, lying partly within and partly without the City of Los Angeles, in the County of Los Angeles, State of California, described as follows:

Beginning at the Northwest corner of said Rancho, said point being Station 6 of the Patent Survey thereof; thence South two (2) degrees West along the West line of said Rancho one hundred thirty-two and forty-four hundredths (132.44) chains; thence South eighty-eight (88) degrees East twenty-seven and eighteen hundredths (27.18) chains to the Easterly line of the four hundred forty-four (444) acre tract allotted to Rita Botiller de Aguilar by final decree of partition of said Rancho, a certified copy of which is recorded in Book 27, Page 74 of Deeds; thence North two (2) degrees East along said Easterly line one hundred sixteen and twenty-eight hundredths (116.28) chains, more or less, to the Northerly line of said Rancho; thence North fifty-seven (57) degrees West along said Northerly line twenty-four and seventy-five hundredths (24.75) chains to Station 4; thence North sixty-five (65) degrees West five (5) chains to Station 5; thence North eighty-two and one-half ($82\frac{1}{2}$) degrees West seventy-three and one-half ($73\frac{1}{2}$) links more or less to a point bearing South

(Testimony of Mr. William E. Ware.)

twenty-one and three-fourths ($21\frac{3}{4}$) degrees East one and fifty-four hundredths (1.54) chains from the point of beginning; thence North twenty-one and three-fourths ($21\frac{3}{4}$) degrees West one and fifty-four (1.54) chains to place of beginning.

Excepting therefrom that portion thereof included in the one hundred (100) foot strip of land conveyed to the Los Angeles and Independence Railroad Company by deed recorded in Book 53, Page 553 of Deeds.

Also excepting that portion thereof described as follows:

Beginning at the intersection of the Northerly line of said one hundred (100) foot strip with the Westerly line of said Rancho; thence Easterly along said Northerly line two hundred ninety-eight (298) feet; thence at right angles Northerly eighty (80) feet; thence Westerly parallel with said Northerly line one hundred (100) feet; thence at right angles Southerly forty-four (44) feet; thence at right angles Westerly one hundred ninety-eight (198) feet; thence Southerly thirty-six (36) feet, more or less, to point of beginning.

Also excepting therefrom the Northerly two hundred feet thereof.

Parcel Two:

That parcel of land situate in the Rancho La Ballona, County of Los Angeles, State of California, described as follows:

Beginning at a point in the Southwest line of the County Road, said point being the most Northerly

(Testimony of Mr. William E. Ware.)

corner of the eighty-six and sixty-six hundredths (86.66) acre tract allotted to Andres Machado by final decree of partition in [86] case No. 2000 of the District Court of said County; thence along the Southwesterly line of said road, South thirty-nine (39) degrees East thirteen and twenty hundredths (13.20) chains to the point of intersection of a water ditch as it existed August 8th, 1887, with the aforesaid Southwest line of said road; thence Southeasterly along the line of said road one and seventy hundredths (1.70) chains; thence South thirty-seven and one-half ($37\frac{1}{2}$) degrees East sixty-seven (67) links to the line of a "wire and board fence" as recited in deed establishing the division line between the properties of C. B. Scott and Daniel M. McGarry recorded in Book 963, Page 257 of Deeds, Records of said County; thence following the line of said fence, South eighty-five (85) degrees thirty-eight (38) minutes West fifty-seven (57) links; thence South seventy-two (72) degrees four (4) minutes West two and sixty-three hundredths (2.63) chains; thence South sixty-three (63) degrees four (4) minutes West five and nine hundredths (5.09) chains; thence South thirteen (13) degrees twenty-six (26) minutes East seventy-four (74) links; thence South twenty-three (23) degrees nine (9) minutes West four and fourteen hundredths (4.14) chains; thence South sixteen (16) degrees fifty-four (54) minutes West four and nine hundredths (4.09) chains; thence South twenty-three (23) degrees

(Testimony of Mr. William E. Ware.)

thirty-eight (38) minutes West three and twelve hundredths (3.12) chains; thence South ten (10) degrees East seven and ninety-three hundredths (7.93) chains; thence South twenty-seven (27) degrees thirty-six (36) minutes West one and seventy hundredths (1.70) chains; thence South thirty-two (32) degrees fifty-nine (59) minutes West three and sixty-four hundredths (3.64) chains; thence South twenty-seven (27) degrees twenty-two (22) minutes West three and sixty-three hundredths (3.63) chains; thence South twenty-two (22) degrees forty-five (45) minutes West ninety-five (95) links, more or less, to a point which is South sixty-six (66) degrees thirty-five (35) minutes East one and twenty-hundredths (1.20) chains; from center line of Ballona Creek; thence North sixty-six (66) degrees thirty-five (35) minutes West one and twenty hundredths (1.20) chains to the center line of said Ballona Creek at the most Northerly corner of the tract of land marked "Augustin Cota 15.205 acres" on map showing part of said Rancho La Ballona recorded in Book 17, Page 77, Miscellaneous Records of said County; thence along the center line of said creek North fifteen (15) degrees East one (1) chain, more or less, to the Northeast corner of the thirty-four and ninety-hundredths (34.90) acre tract described in deed from D. M. McGarry and wife to Louis Salzeber, recorded August 1st, 1899, in Book 1301, Page 261 of Deeds; thence North fifty-five (55) degrees fifty-five (55) minutes West sixteen

(Testimony of Mr. William E. Ware.)

and forty hundredths (16.40) chains, more or less, to the Northwesterly line of said eighty-six and sixty-six hundredths (86.66) acre tract; thence along said Northwesterly line on a course of about North thirty-one and one-half ($31\frac{1}{2}$) degrees East thirty-eight and twenty-seven hundredths (38.27) chains, more or less, to the point of beginning. [87] including all buildings and improvements thereon or that may be hereafter erected thereon; together with all and singular the tenements, hereditaments and appurtenances, water and water rights, pipes, flumes and ditches thereunto belonging or in anywise appertaining, the reversion, remainder and remainders, rents, issues and profits thereof, for the purpose of securing:

First. The performance of the promises and obligations of this mortgage and the payment of the indebtedness evidenced by a promissory note (and any renewal or renewals thereof) in words and figures as follows:

\$175,000.00

Los Angeles, California, November 12, 1929

Five years after date, for value received Artesian Water Company, a California Corporation, promises to pay to The Pacific Mutual Life Insurance Company of California, or order, at its office in Los Angeles, the sum of one hundred seventy-five thousand Dollars, with interest from date until paid, at the rate of six (6) per cent. per annum, payable

(Testimony of Mr. William E. Ware.)

quarterly, should the interest not be so paid, it shall become a part of the principal and thereafter bear like interest as the principal. Should default be made in the payment of any installment of principal or interest when due, then the whole sum of principal and interest shall become immediately due and payable at the option of the holder of this note. Principal and interest payable in lawful money of the United States. This note is secured by a mortgage upon real property of even date herewith.

[Corporate ARTESIAN WATER COMPANY

Seal] By M. K. RINDGE

President

By A. S. COOPER

Secretary

Second: The payment of such additional sums, with interest, as may hereafter be loaned by said mortgagee to said mortgagor or assigns, whether evidenced by promissory note or otherwise.

Third. The payment of attorney's fees in a reasonable sum to be fixed by the Court in any action brought to foreclose this mortgage, or in any action, suit or proceeding affecting the rights of the mortgagee herein, whether brought by or against the owner of said real property, involving either the title thereto, the lien of this mortgage thereon, the validity or priority of such lien, or any right of the mortgagee hereunder, whether such action, suit or

(Testimony of Mr. William E. Ware.)

proceeding progress to judgment or not; also the payment of all costs and expenses of such suit and also such sums as said mortgagee may pay for obtaining a policy of title insurance and for searching the title to the mortgaged property subsequent to the date of the recording of this mortgage or for surveying said property; also, whenever it becomes necessary for said mortgagee, in its judgment, to make any appearance in court in connection with the property herein mortgaged the payment of all court costs, and such attorney's fees as shall be paid, or agreed to be paid, by said mortgagee; all of which said sums, including said attorney's fees, are hereby declared a lien upon said property and are secured hereby.

Fourth. The payment of all sums expended or advanced by the mortgagee for taxes, assessments, encumbrances, adverse claims, fire, cyclone or tornado insurance, inspection, repair, cultivation, irrigation, protection, fertilization, fumigation or any other expenditure in connection with the care, preservation or maintenance of said property, or for any other purpose provided for by the terms of this mortgage.

The mortgagor agrees with said mortgagee to pay, as soon as due, all taxes, assessments, liens and encumbrances, which may be, or appear to be, liens upon said property or any part thereof, while the indebtedness, or any part thereof hereby secured, remains unpaid, including taxes levied or assessed

(Testimony of Mr. William E. Ware.)

upon this mortgage or upon the debt secured hereby, and hereby waives all right to treat the payment of such taxes or assessment as a payment on the debt secured hereby or as being to any extent a discharge thereof. [88]

And the mortgagor agrees to keep the buildings now erected or which may hereafter be erected on said premises, insured against loss by fire in an amount equal to the principal sum of said promissory note (or less if satisfactory to the mortgagee) in such companies as may be satisfactory to the mortgagee, the policies for such insurance shall be made payable, in case of loss, to said mortgagee, and shall be delivered to and held by it as further security; and that in default thereof, said mortgagee may procure such insurance, not exceeding the amount aforesaid, to be effected either upon its interest as mortgagee or upon the interest of the owner of the mortgaged premises, and in its name, loss, if any, being made payable to the said mortgagee, and may pay and expend for premiums for such insurance such sums of money as it may deem to be necessary; and the mortgagor further agrees promptly to pay and settle, or cause to be removed by suit or otherwise, all adverse claims against said property.

In case said taxes, assessments or encumbrances so agreed to be paid by the mortgagor be not so paid, or said buildings so insured and said policies so made payable, in case of loss, to said mortgagee,

(Testimony of Mr. William E. Ware.)

or said adverse claim so paid, settled or removed, then the mortgagee, being hereby made the sole judge of the legality thereof, may, without notice to the mortgagor, pay such taxes, assessments or encumbrances, obtain such policies of insurance, not exceeding the amount aforesaid, to be effected either upon its interest as mortgagee or upon the interest of the owner of the mortgaged premises, and in its name, loss, if any, being made payable to the said mortgagee, and pay or settle any or all such adverse claims, or cause the same to be removed by suit or otherwise.

The mortgagor agrees to keep said property in good condition and repair and to permit no waste thereof, and should said property, or any part thereof, require any inspection, repair, cultivation, irrigation, fertilization, fumigation, or protection, other than that provided by the mortgagor, then the mortgagee, being hereby made the sole judge of the necessity therefor, and without notice to the mortgagor may enter, or cause entry to be made, upon said property, and inspect, repair, cultivate, irrigate, fertilize, fumigate, or protect said property as it may deem necessary. All sums expended by the mortgagee in doing any of the things above authorized are secured hereby and shall be paid to the mortgagee by the mortgagor in said gold coin, on demand, together with interest from the date of payment, at the same rate of interest and in the same manner as is provided to be paid in the note hereinbefore set out.

(Testimony of Mr. William E. Ware.)

In the event of a loss under said policies of fire insurance, the amount collected thereon shall be credited first to the interest due, if any, upon said indebtedness, and the remainder, if any, upon the principal sum; and interest shall thereupon cease on the amount so credited on said principal sum.

The mortgagor hereby agrees, during the life of this mortgage, that, if application be made to have the premises described herein registered under the "Land Title Law," effective December 19, 1914, or any amendment thereof, or any other law governing the registration of titles to land, the mortgagor will at once repay all costs, expenses and attorney's fees incurred and deemed by the mortgagee to be necessary for the protection of its interests in connection with such applications; and all moneys advanced by the mortgagee for any such purposes, with interest at same rate as provided in the note or notes secured hereby, are hereby declared a lien upon said property. and are secured hereby. The mortgagor further agrees that, in case of such registration, said mortgagor will cause a certified copy of the certificate so issued, by virtue of such proceedings, to be delivered to the mortgagee as soon as issued.

The mortgagor promises to pay said note according to the terms and conditions thereof; and in case of default in the payment of same, or of any installment of interest thereon when due, or if default be made in the payment of any other of the

(Testimony of Mr. William E. Ware.)

moneys herein agreed to be paid, or in the performance of any of the covenants or agreements herein contained on the part of the mortgagor, the whole sum of money then secured by this mortgage shall become immediately due and payable at the option of the holder of said note, and this mortgage may thereupon, or at any time during such default, be foreclosed, and the filing of the complaint in foreclosure shall be conclusive notice of the exercise of such option by the mortgagee.

The plaintiff in such suit of foreclosure shall be entitled, without notice, to the appointment of a receiver, to collect and receive the rents, issues and profits of the mortgaged premises, and to exercise such other powers as the Court shall confer.

It is also agreed that should this mortgage be foreclosed, then in the decree of foreclosure entered in such action, the property described therein may be ordered sold *en masse*—or as one lot or parcel, at the option of the mortgagee.

And also, that the mortgagee may at any time, without notice, release portions of said mortgaged premises from the lien of this mortgage, without affecting the personal liability of any person for the payment of the said indebtedness or the lien of this mortgage upon the remainder of the mortgaged premises for the full amount of said indebtedness then remaining unpaid.

The mortgagor hereby mortgages the property hereinbefore described, to secure the performance

(Testimony of Mr. William E. Ware.)

of every promise and agreement herein contained, direct or conditional, and to secure the repayment to the mortgagee of all sums paid, laid out or expended by the said mortgagee under the terms of this mortgage, and also to secure the attorney's fees and costs provided for by this mortgage in case of a foreclosure thereof.

Every covenant, stipulation and agreement herein contained shall bind and inure to the benefit of said parties, their successors, heirs, executors, administrators or assigns.

Witness the corporate name and seal of the Mortgagor the day and year first above written, by its President and Secretary thereunto authorized.

ARTESIAN WATER COMPANY [Seal]

By M. K. RINDGE

[Seal]

President

By A. S. COOPER

[Seal]

Secretary

Signed and Sealed in Presence of

.....
.....

[Cancelled 7-25-38 R.N.D.] [89]

75

ORDER NO.

NO. 6509

When recorded please mail to The Pacific Mutual Life Insurance Company of California, Los Angeles, Cal.

COMPAREND

Read by
NELSON
Document

HURST

RECORDED AT REQUEST OF
THE ARTESIAN WATER TRUST CO.

ON 23 1929 AT 3:30 P. M.

Book 9596 Page 14

Official
Hurst, Los Angeles County, Cal.

Original County Recorder

that I have correctly transcribed

document in my mentioned book

W. C. Recorder's Office L. A. County

409
36

Mortgage

ARTESIAN WATER COMPANY

TO

The Pacific Mutual Life Insurance Company of California



PACIFIC MUTUAL BUILDING
Los Angeles, California

STATE OF California
COUNTY OF Los Angeles
On this 22 day of November, in the year of our Lord, one thousand nine hundred and Twenty-nine before me, Emma E. Constat, a Notary Public in and for said County of Los Angeles, residing therein, duly commissioned and sworn, personally appeared Wm. K. Rindge, known to me to be the President, and A. S. Cooper, known to me to be the Secretary of

Artesian Water Company, the corporation described in and that executed the within instrument, and known by me to be the persons who executed the within instrument on behalf of the corporation therein named, and acknowledged to me that such corporation executed the same.

IN WITNESS WHEREOF, I have hereunto set my hand and affixed my Official Seal, the day and year in this certificate first above written.

Emma E. Constat

Notary Public in and for the County of Los Angeles State of California
(CORPORATION)
My commission will expire Nov. 9, 1931

STATE OF _____
COUNTY OF _____
On this _____ day of _____ in the year of our Lord, one thousand nine hundred and _____ before me, _____, a Notary Public in and for said County of _____, residing therein, duly commissioned and sworn, personally appeared _____

known to me to be the person _____ whose name _____ subscribed to the within instrument, and _____ acknowledge to me that he executed the same.

IN WITNESS WHEREOF, I have hereunto set my hand and affixed my Official Seal, the day and year in this certificate first above written.

U. S. BOARD OF TAX APPEALS
DIV. 15 DOCKET 00130
JUN 11 1940
PETITIONER'S EXHIBIT 4
RESPONDENT'S

Notary Public in and for the County of _____ State of _____
[CORPORATION]

(Testimony of Mr. William E. Ware.)

By Mr. Witter:

Q. Now, did the mortgage that was given to secure these notes comprise substantially all of the properties of value of the Artesian Water Company, or otherwise?

A. I believe the property known as the Home Villa property was not included, which is a subdivision property. But it represents substantially the major portion of the assets of the company, yes.

Q. Does the mortgage include all of the income-producing properties of the company with respect to the year 1937, the taxable year? A. Yes.

[47]

Q. Now, these notes matured on November 12, 1934. Were they paid on that date, Mr. Ware?

A. They were not.

Q. And on what date were you appointed receiver? A. July 16, 1935.

Q. Had any payment been made upon these notes at the time you were appointed receiver?

A. No.

Q. What steps did you take, if any, to effect any payment upon these notes as receiver?

A. During the year 1936 I attempted to secure an extension of time on these notes and submitted a proposal to Mr. Green, who was then the head of the Mortgage Loan Department of the Pacific Mutual, proposing the payment of I believe it was \$20,000 on the then indebtedness, and amortize it at the rate of \$2750 a month, plus interest.

(Testimony of Mr. William E. Ware.)

Negotiations continued for some little time to take the matter up with the Board, but in the interim, while these negotiations were going on the conservator was appointed for the Pacific Mutual Life Insurance Company. This loan was severely criticised by the conservator because of certain interlocking interests. Mr. George Cochran, who was then the president of the Pacific Mutual Life Insurance Company and Mr. Samuel Ringe, who was a member of the Board of Directors of the Pacific Mutual [48] Life Insurance Company, Mr. Lee Phillips, and Mr. Stanley McLung were all interested in the Artesian Water Company as stockholders. The conservator felt that inasmuch as there was this interlocking interest that the loan should be paid immediately, and so called the loan.

I then tried to secure a further extension of time in order to attempt to refinance, if possible. The results of these discussions were that the Pacific Mutual, the conservator for the Pacific Mutual Life Insurance Company, stated that they would give me until March of 1937 to refinance the loan, at which time if I was unsuccessful they would expect full payment.

I attempted to approach various brokers and banks for a refinancing but was met with the objection that the company being in receivership they were afraid that proper title could not be passed and that who would be available to sign the mortgage loan or create the indebtedness.

(Testimony of Mr. William E. Ware.)

In the meantime, I had been negotiating with the Shell Oil Company, who were the owners of the lease, in an effort to get them to further exploit the——

Q. Pardon me. I will introduce the correspondence you had with respect to extending the time for payment.

The Clerk: This document will be marked for identification Petitioner's Exhibit No. 5. And this will be marked Petitioner's Exhibit No. 6. [49]

(The said documents so offered were marked Petitioner's Exhibits 5 and 6 for identification.)

By Mr. Witter:

Q. Mr. Ware, I show you what has been marked for identification Petitioner's Exhibit No. 5, and I will ask you to state what it is.

A. This represents a copy of a letter written by myself as receiver to the Pacific Mutual Life Insurance Company under date of July 17, 1936 in which the matter of the unpaid principal balance of \$175,000 and \$35,000 respectively were discussed.

Mr. Witter: Your Honor doesn't care to have these letters read?

The Member: If they are introduced as exhibits it won't be necessary.

Mr. Witter: I will offer in evidence then Petitioner's Exhibit No. 5.

Mr. Tonjes: No objection.

(Testimony of Mr. William E. Ware.)

The Member: It will be received as Petitioner's Exhibit No. 5.

(The document so offered and received in evidence, was marked Petitioner's Exhibit 5, and made a part of this record.) [50]

PETITIONER'S EXHIBIT No. 5

650 South Grand Avenue

July 17, 1936

Pacific Mutual Life Insurance Company

523 West Sixth Street

Los Angeles, California

Attention—Mr. Green:

In re: Artesian Water Company

Gentlemen:

You will recall that a short time ago you requested that I discuss with you the matter of the loans heretofore made by you to the Artesian Water Company, upon which there remain unpaid principal balances of \$175,000 and \$35,000 respectively. Such loans are now in default as to principal and you have suggested that some arrangement be made to correct such defaults.

I have considered the matter in detail with a view to ascertaining what course the company can adopt to satisfy your requirements. You understand, of course, that as receiver for the company I have no power to make any commitments on its behalf, but must submit any tentative arrangements which we may make to the superior court, and that

(Testimony of Mr. William E. Ware.)

I desire to secure the consent of the board of directors of the company to any proposed settlement. I am inclined to believe, however, that I might be able to obtain the approval of the board of directors and the court of the payment of \$10,000 for application upon the principal of one or the other obligation and a new plan contemplating the payment of the balance of \$200,000 in five years with interest at the rate of five per cent per annum, payable quarterly. Since the company desires to liquidate its indebtedness at the earliest possible moment, such plan should make provision for the payment of any multiple of \$1,000 upon any quarterly interest date without penalty.

I further believe that, under present conditions, the company could pay about \$6,000 quarterly on account of principal and in the absence of unforeseen events should continue so to do.

In the event the above suggestions are not satisfactory to you, I would be happy to have the benefit of your ideas in the matter. Will you kindly communicate with me at your convenience.

Very truly yours,

WILLIAM E. WARE

Receiver—Artesian Water Company

WEW:M

C.C. to—

Mr. Marvin Osburn

Mr. Sam Rindge

Mr. William Larrabee

[Endorsed]: Petitioner's Exhibit No. 5. Admitted in evidence June 11, 1940. [91]

(Testimony of Mr. William E. Ware.)

By Mr. Witter:

Q. I show you what has been marked for identification Petitioner's Exhibit No. 6 and ask you if that is the reply of the Pacific Mutual Company to the letter marked Petitioner's Exhibit No. 5 which you yourself wrote.

A. This is a reply to my letter. But there were some discussions in the interim between the dates of this letter and this letter, which were more or less informal discussions with the Pacific Mutual Life Insurance Company.

Mr. Witter: I offer in evidence Petitioner's Exhibit No. 6.

Mr. Tonjes: No objection.

The Member: It will be received as Petitioner's Exhibit No. 6.

(The said document so offered and received in evidence, was marked Petitioner's Exhibit 6, and made a part of this record.)

(Testimony of Mr. William E. Ware.)

PETITIONER'S EXHIBIT No. 6

Pacific Mutual Life Insurance Company

Los Angeles, California

September 14, 1936

6509—Artesian Water Company

Artesian Water Company

650 South Grand Avenue

Los Angeles, California

Attention: William E. Ware, Receiver

Gentlemen:

Please be referred to the above numbered loan standing at an unpaid principal balance of \$210,000, which has been running past due since November 12, 1934, and which is secured by mortgage recorded in Book 9596, page 14, of Official Records, Los Angeles County, California.

Subject to our being able to obtain court authority to so do, we shall extend informally the time for payment of this obligation until March 2, 1937, provided—

(1) That you pay us within fifteen days from this date the sum of \$18,500 in cash, and \$3,500 on the first day of each month during said extension period commencing October 1st next, said sums as received to be applied toward liquidation of the principal of this obligation; and

(2) That interest is to be at the rate of six (6) per cent. per annum from August 12, 1936,

(Testimony of Mr. William E. Ware.)

payable quarterly, and the extension is to be subject otherwise to compliance with all terms of the original note and mortgage.

We are instructed to inform you that no further extensions of time for payment of this loan will be granted after March 2, 1937, and you will kindly make arrangements to retire this obligation not later than said date.

Very truly yours,

PACIFIC MUTUAL LIFE INSURANCE COMPANY

By JOHN B. COOLEY,

Manager Mortgage Loan Department.

JBC/D

[Endorsed]: Petitioner's Exhibit No. 6. Admitted in evidence June 11, 1940. [92]

By Mr. Witter:

Q. Going back just a moment.

When these notes matured in 1934, Mr. Ware, if you know, was there a request for an extension of time made upon Pacific Mutual Company, and was that request refused?

A. I was not present. I don't know of my own knowledge that that was done except from subsequent correspondence and reference to notations I found in the file, [51] that was the case.

Q. In Petitioner's Exhibit 6, which is the response to your letter to the Pacific Mutual Company

(Testimony of Mr. William E. Ware.)

requesting extension of time, they give you until March 3, 1937 to make payment in full. Were you able to make payment in full on that date?

A. I was not.

Q. Did you make strenuous efforts to meet their terms laid down in that letter? A. I did.

Q. And were you wholly unable to meet the terms that they laid down in that letter?

A. I was.

Q. Now, the total indebtedness of these notes in principal amount at the time you became receiver was \$210,000, is that correct?

A. That is correct.

Q. In the year 1936, how much were you able to pay off on that principal?

A. Approximately \$25,000.

Q. So that on January 1, 1937 there was approximately \$185,000 still due on the principal indebtedness? A. That is correct.

Q. And during the year 1937 how much were you able to reduce this \$185,000 still owing? [52]

A. May I see the company's tax returns?

(The document referred to was passed to the witness.)

The Witness: It was reduced to a balance of \$100,250.

By Mr. Witter:

Q. What did the income of the company consist of?

(Testimony of Mr. William E. Ware.)

A. Approximately ninety per cent of it was from the royalties of the oil lease.

Q. Did at least ninety-seven per cent consist of oil royalties?

A. I didn't figure the percentage, but it could be.

Q. Is it true that substantially all of the income consisted of oil royalties? A. That is true.

Q. I will ask you whether or not the total oil royalties from any oil leases that the company had had been assigned to the Pacific Mutual Company?

A. They had.

Q. And had the Pacific Mutual Company merely permitted the Artesian Water Company to collect the royalties during such time as it saw fit to do so under that assignment?

A. That is correct.

Q. Mr. Ware, what was the condition of the Artesian Water Company at the beginning of the taxable year so far as [53] undivided profits or an operating deficit were concerned?

Mr. Tonjes: That is objected to, Your Honor, as calling for a conclusion and not the best evidence.

The Member: Well, I would think of course that the best evidence would be the books of the corporation. Did they have a balance sheet at that time?

Mr. Witter: Well, if Your Honor please, he was in the position of a taxpayer himself. He is an auditor. Could not he know of his own knowledge that a deficit or an undivided surplus existed on that date?

(Testimony of Mr. William E. Ware.)

The Member: Well, that is probably true, yet I should think that it would be a little risky to have a witness testify from memory as to just what that is. It seems to me that the best evidence would be the balance sheet of the company. Isn't that available?

Mr. Witter: It is on the income tax return. He possibly has it among his papers.

Do you have it, Mr. Ware?

The Witness: I don't have it in 1936. It is on the tax return.

The Member: If it is on the tax return he can read it as shown by the tax return.

By Mr. Witter:

Q. To refresh your recollection then, I will show you the balance sheet that accompanied the 1937 return filed by [54] the company and ask you whether or not there was a deficit at the beginning of the taxable year 1937, and if so how much?

A. There was a deficit of \$50,571.90.

The Member: That is as shown by the balance sheet attached to the 1937 income tax return as filed and examined by the department.

By Mr. Witter:

Q. And at the end of the taxable year that deficit had been reduced? A. It had.

Q. And what was the condition?

A. There was an undistributed profit of \$34,442.50.

The Member: Instead of a deficit?

(Testimony of Mr. William E. Ware.)

The Witness: Instead of a deficit. At the close of the year.

By Mr. Witter:

Q. While you were receiver for the company, did you have to obtain an order of the Court for any transaction of any consequence that took place?

A. Yes.

Q. Whenever you made a payment upon one of these notes, for instance, did you have to obtain an order of the Court? A. I did. [55]

Q. Were you wholly under the supervision of the Court in everything that you did?

A. I was.

Q. Did you take any action that wasn't supported either specifically or generally by an order of the Court? A. I did not.

Mr. Witter: I will ask that this be marked for identification, Mr. Clerk.

The Clerk: It will be marked Petitioner's Exhibit 7 for identification.

(The said document so offered, was marked Petitioner's Exhibit 7, for identification.)

By Mr. Witter:

Q. I hand you what has been marked for identification Petitioner's Exhibit 7 and ask you if that is a copy of an order that you obtained from the Court for making a payment upon the notes owned by the Pacific Mutual Company. A. It is.

Q. And is that a representative order such as

(Testimony of Mr. William E. Ware.)

you obtained each time you made any payment upon these notes? A. It is.

Mr. Witter: I offer in evidence Petitioner's Exhibit No. 7.

Mr. Tonjes: No objection. [56]

The Member: It will be received in evidence as Petitioner's Exhibit No. 7.

(The said document so offered and received in evidence, was marked Petitioner's Exhibit 7, and made a part of this record.)

PETITIONER'S EXHIBIT NO. 7

In the Superior Court of the State of California
in and for the County of Los Angeles

No. 390338

J. C. BALDWIN,

Plaintiff,

vs.

FREDERICK H. RINDGE, et al.,

Defendants.

ORDER AUTHORIZING RECEIVER TO MAKE
PAYMENT ON PRINCIPAL OF NOTE SE-
CURED BY MORTGAGE AND ASSIGN-
MENT OF LEASES.

The Petition of Receiver for Instructions and Authority to Make Payment on Principal of Note Secured by Mortgage and Assignment of Leases, dated February 18, 1938, filed by the receiver here-

(Testimony of Mr. William E. Ware.)

in, coming on regularly for hearing on February 23, 1938, in Department 34 of the above entitled court, and it appearing that due and legal notice of the time and place of the hearing of said petition has been given to all the parties interested herein, and no person appearing to oppose the same, and evidence having been introduced in support of said petition,

It Is Hereby Ordered that said petition be granted, and that William E. Ware, as receiver for the Artesian Water Company, a corporation, is instructed and authorized to make payment, at this time, of Thirty Thousand Dollars (\$30,000.00), on account of the principal of the indebtedness described in his petition, to Pacific Mutual Life Insurance Company, a corporation; said payment to be in excess of the monthly payments of Twenty-seven Hundred Fifty Dollars (\$2,750.00) being made by him, as described in said petition.

Dated: February 23, 1938.

WILSON

Judge

[Endorsed]: Petitioner's Exhibit No. 7. Admitted in evidence June 11, 1940. [93]

Mr. Witter: Mr. Clerk, will you mark this document for identification?

The Clerk: It will be marked for identification as Petitioner's Exhibit No. 8.

(Testimony of Mr. William E. Ware.)

(The said document so offered was marked
Petitioner's Exhibit 8, for identification.)

By Mr. Witter:

Q. I hand you what is marked for identification
Petitioner's Exhibit No. 8 and ask you if that is
a true copy of the by-laws of the Artesian Water
Company.

A. It appears to be the copy of the by-laws as I
saw them.

Mr. Tonjes: Do you know, Mr. Ware?

The Witness: I haven't compared it.

Mr. Witter: I didn't compare it with the orig-
inal. It was given to me by the taxpayer company
as a true copy of the by-laws of the corporation.
I don't desire to introduce it in evidence. I merely
desire to read into the record one provision which
states the powers of a director [57] so far as de-
claring dividends is concerned.

Mr. Tonjes: I don't like to object to the com-
petency of the document, Your Honor, but I will
object to the offer.

The Member: Go ahead and make your offer.

By Mr. Witter:

Q. Mr. Ware, you have seen the original by-
laws of the company? A. I have.

Q. And you are familiar with them and their
contents? A. I have read them, yes.

Q. Well, I will ask you to read Petitioner's
Exhibit 8 and state whether or not that is a true
copy.

A. This appears to be a copy of the by-laws.

(Testimony of Mr. William E. Ware.)

Q. Mr. Ware, calling your particular attention to the second paragraph in Article 5 of the by-laws, I will ask you if you recall that that is a true copy of the provision.

A. I would say it was, yes, because I have read that several times in connection with this matter.

Q. That purports to state the powers of the directors so far as declaring dividends is concerned?

A. Yes.

Q. And this is a correct copy of what appears in the original so far as that power is concerned?

A. Yes. [58]

Mr. Witter: If Your Honor please, I do not desire to introduce this entire document because there is only one sentence here that has any bearing on the case.

I would like to read that into the record.

Mr. Tonjes: That is objected to, Your Honor, on the ground that it is incompetent. I will waive the objection with respect to competency. It is immaterial. That the by-laws of a corporation have never been held to be a contract which would either restrict or not restrict the payment of dividends by a corporation in so far as it applies to a contract under the provisions of the Revenue Act.

The Member: I will overrule the objection.

Mr. Witter: Article 5 of Petitioner's Exhibit 8, which purports to be a true copy of the by-laws of the Artesian Water Company, reads as follows: "Duties of Directors. It shall be the duty of di-

(Testimony of Mr. William E. Ware.)

rectors (second) to declare dividends out of the surplus profits when such profits shall in the opinion of the directors warrant the same.”

If Your Honor please, from a recent case it appeared that the Board of Tax Appeals did not take judicial notice of the code provisions of a state.

The Member: That is news to me.

Mr. Witter: It was news to me. [59]

Because of what I inferred from that recent decision, I came prepared to prove the laws of this state with respect to certain matters in this case. But if the Board takes judicial notice of those statutes then that proof isn't necessary.

The Member: We always have.

I am not aware of any decision of the Board that holds it is necessary to introduce into evidence the statute of the state or of the United States. Of course when it comes to a foreign law that has to be proved. But I think you surely must be mistaken as to any Board case.

Mr. Witter: It wasn't a Board decision, Your Honor. I am sorry I don't recall exactly which one it was. But it was on appeal.

The Member: I certainly have always taken judicial notice of the code of the state.

Mr. Tonjes: If Your Honor please, to clarify things, I will be willing to stipulate the Board might take judicial notice of all of the states' statutes.

(Testimony of Mr. William E. Ware.)

The Member: Yes.

That will be stipulated although I think it is unnecessary. However, you may note it in the record.

Mr. Witter: If Your Honor will bear with me for just a moment, I think I will be through. [60]

By Mr. Witter:

Q. Mr. Ware, you have stated the operating deficit that existed at the beginning of the year and the amount of undivided profits at the end of the year. I will ask you whether or not in arriving at those amounts that you have stated any deduction was taken for depletion.

Mr. Tonjes: That is objected to as being immaterial, Your Honor.

The Member: Well, I will overrule the objection. I am not prepared to say it would be immaterial at this time.

The Witness: There was not.

By Mr. Witter:

Q. Virtually all of the income that reduced the deficit was income derived from oil royalties?

A. Yes.

Q. And yet no depletion deduction was taken?

A. In the surplus account.

Q. I will ask you if you are able to say, in your opinion, as an auditor and as a receiver for the company in the taxable year, if the proper deduction had been taken for depreciation would

(Testimony of Mr. William E. Ware.)

there have been any undivided profits balance at the end of the taxable year?

A. May I see the return?

(The document referred to was passed to the witness.) [61]

The Witness: There would have been no surplus without depletion. I say there would have been no depletion surplus if depletion had not been credited back to surplus.

Mr. Tonjes: I ask that the answer be stricken and the witness re-answer the question.

The Member: If he can give the gross income from oil royalties, why then it would be a mathematical calculation I suppose to figure what the depletion would be, the percentage depletion was.

The Witness: In order to answer that question, the tax return for the year shows an undivided profit at the end of the year of \$34,442.50. If that was reduced by the depletion of \$44,863.38 there would be a deficit of approximately \$10,400.

The Member: That is a better way to state it. That gives the figures.

By Mr. Witter:

Q. Suppose the depletion had been figured on a cost-depletion basis, are you able to state whether there would have been undivided profits at the end of the year? A. I wouldn't.

Q. Would the undivided profits at the end of the year then have been materially reduced?

(Testimony of Mr. William E. Ware.)

A. They would. [62]

Q. They would if depletion had been taken on a cost basis? A. That is right.

Q. Now, during the year 1937, when you were receiver for this company, I ask you, Mr. Ware, if you were able to make adequate provisions for meeting the debts and liabilities of the Artesian Water Company?

Mr. Tonjes: That is objected to, Your Honor, as calling for a conclusion.

The Member: I will overrule the objection.

The Witness: May I have the question?

(Whereupon, the reporter read the question as recorded.)

By Mr. Witter:

Q. As they matured? A. I was not.

Mr. Witter: That is all.

Cross Examination

By Mr. Tonjes:

Q. Mr. Ware, you stated that you were unable to meet or make arrangements for payment of debts as they matured. Which debts matured which could not be met?

A. The Pacific Mutual debts.

Q. Did you make arrangements with them to extend the time?

A. There was no definite arrangement as to extension. [63]

(Testimony of Mr. William E. Ware.)

Q. Did they take any legal proceedings against the corporation?

A. They started to take legal proceedings and then due to their own difficulties on some of their own matters they deferred the action with a more or less of a reservation that practically all of the income of this company would be diverted to them.

Q. Did the company become involved in any legal proceedings on account of its inability to pay its bills? A. No.

Q. And to the best of your knowledge all of its bills were paid?

A. Except this one obligation that was past due.

Q. That obligation was somewhat past due?

A. Yes. This obligation was past due since 1934.

Q. Now, what efforts did you make to obtain funds to refinance the loan to the Pacific Mutual Company?

A. I approached the loaning officers of the California Bank, the Security First National Bank, and two or three other bankers in town with the idea of attempting to put a new loan on to take the Pacific Mutual out.

Q. And what was the outcome of those negotiations?

A. They all fell through due to the fact that none of the loaning officers felt that they could make a new loan signed by the receiver. The title companies, in [64] other words, would not issue title satisfactory to the loaning agency.

(Testimony of Mr. William E. Ware.)

Q. It was more on account of a lack of ability to give good collateral in that they couldn't pass good title rather than the value of the collateral, is that correct?

A. No, I wouldn't say that because the value was more or less unknown. I recall that in the negotiations with the Security Bank they spent considerable time in the appraising. They had some idea of the values of these properties. They felt that because of the fact the title company couldn't be brought down that they wouldn't go any further with it. But I don't know the exact figures that they used in connection with their investigation.

Q. But the company did produce sufficient oil to have paid to them in the year 1937 royalties in the amount of \$175,000, is that correct?

A. Whatever the tax return shows. I don't have the information in front of me.

Mr. Witter: Do you mean gross royalties received, Mr. Tonjes?

Mr. Tonjes: Yes.

Q. I will amend my statement. I will change that figure to royalties in the amount of \$163,139.56. Would you say that that is correct?

A. Yes.

[65]

Q. And the company also had some other items which produced income, did it not?

A. It did.

Q. And that was in the form of rents?

A. Some rents, some interest.

(Testimony of Mr. William E. Ware.)

Q. And what was the nature of the property which produced the rents?

A. Some houses on Home Villa tract principally, and there were also some rentals from farming leases on the vacant acreage, and some rental from the Asphalt Paving Company which had a portion of the property on the Sentous property.

Q. Did the income from such properties during 1937 amount to \$8,353.86?

Mr. Witter: Is that gross income, Mr. Tonjes?

The Witness: Yes. That is the gross income from rentals.

By Mr. Tonjes:

Q. Do you know whether or not the property producing these rentals was incumbent?

A. Some of it was and some of it was not. The portion that produced the major portion of that revenue was incumbent.

Q. Can you show me on the balance sheet of the corporation wherein the incumbrances against such properties [66] are recorded?

A. They are under the item of Bonds, Notes, Mortgages Payable, Item 12 on the balance sheet.

Q. Does that include the indebtedness to the Pacific Mutual Company? A. It does.

Q. How much of it relates to the Pacific Mutual Company's indebtedness and how much to others, if you know?

A. At the end of 1937 the only indebtedness was due to the Pacific Mutual Life Insurance Com-

(Testimony of Mr. William E. Ware.)

pany. There was no other indebtedness on mortgage loans.

Q. Then the Pacific Mutual Company was a creditor and held license on both the oil property and the other properties of the Artesian Water Company, is that correct? A. That is correct.

Q. The corporation carries on its balance sheet an item Land and Buildings carried at a figure of somewhat in excess of one million dollars at the beginning of the taxable year, and \$999,000 at the close of the taxable year. Did you know the circumstances under which the properties in question were valued?

A. Yes. Most of the values appearing on the books are based upon the March 1, 1913 values of the properties of the company.

Q. Would you say that that March 1, 1913 value and [67] the value in 1937 were substantially different?

A. Well, I am not a real estate man and I cannot appraise values. I wouldn't know. I would say there would be a substantial difference based upon sales that were actually made.

Q. Would you say the value was greater in 1937 than in 1913, or less?

A. The value in 1937 would be less than in 1913.

Q. Would be less? A. Yes.

Q. And on what do you base such an opinion?

A. Largely upon the sales of property that were

(Testimony of Mr. William E. Ware.)

made in the subsequent years showing losses over the values of 1913.

Q. Now, when the Pacific Mutual Company advanced money to the Artesian Water Company did the Artesian Water Company assign to the Pacific Mutual Company the Shell Oil lease?

A. It did.

Q. And under the terms of that lease, or under the terms of that loan rather, did the Shell Oil Company continue to pay all of the royalties to the Artesian Water Company? A. It did.

Q. And that was true during the entire year 1937? [68] A. That is right.

Q. Now the Artesian Water Company you say became involved in a receivership proceeding. Was that in the year 1934? A. 1935.

Q. Will you explain to the Board the circumstances of that receivership proceeding?

A. That receivership arose out of an action by one J. Baldwin against Frederick Ringe who was a stockholder of the Artesian Water Company. It appeared that Baldwin had a judgment of some \$200,000 against Frederick Ringe. After considerable investigation they located a safe deposit box in Stockton, California, and in this box there were some stock of the Artesian Water Company, some of the Marblehead Land Company, and some of the Ringe Company. The stock was acquired by Baldwin under sheriff's sale and application was made to these corporations to have the stock trans-

(Testimony of Mr. William E. Ware.)

ferred to Baldwin. The corporate officers refused to transfer the certificates and counsel for Baldwin petitioned the Superior Court of this county for the appointment of a receiver ex parte, on the grounds that the corporate officers were not functioning under the code.

Under that action the Court appointed me as receiver.

Q. And in that connection was the question of in- [69] solvency or was the insolvency of the Artesian Water Company in any way involved?

A. I believe one of the grounds in the application for the receiver alleged fraud and conspiracy and mismanagement on the part of the corporation.

Q. This was not an action brought by a creditor against the corporation?

A. No, it was not. It was a stockholder presumably.

Q. When were you appointed receiver?

A. July 16, 1935.

Q. And when did you terminate your receivership? A. February 8, 1939.

Q. Now, what efforts were made in the meantime to have the receivership terminated by the stockholders?

A. At the original appointment an appeal was filed on the appointment of the receiver. An amended complaint was filed I believe in October of 1936, if my memory serves me. And in the amended complaint an allegation was set up I believe. There was

(Testimony of Mr. William E. Ware.)

a deadlock on the board. I was discharged under the original appointment and reappointed under the amended complaint.

Q. Then as I get it, neither the appointment of the receiver nor the continuation of the receivership was brought about by reason of the inability of the company to pay its bills, is that correct? [70]

A. Not brought about by that, no. But because of the negotiations that were going on with the Pacific Mutual Life Insurance Company for the extension of this loan, there was a more or less of a desire on the part of the corporation itself to permit the receiver to continue because they themselves in taking part would have been faced with the immediate calling of that loan and the assignment of all the income; while as long as the receiver was in and in control of the property the Pacific Mutual Life Insurance Company felt that whatever funds were coming to the company would be paid to them on their loan; and they virtually made the statement to one of the directors at one time that if the receivership were discontinued they would expect to immediately start action.

Mr. Tonjes: I think that is all.

Redirect Examination

By Mr. Witter:

Q. Mr. Tonjes has called to your attention certain rental income received by the company. I ask you to look at a copy of the income tax return and

(Testimony of Mr. William E. Ware.)

state any deductions that are taken on that return that would apply against that rental gross income.

A. Well, there is \$4518.05 for the repairs and some depreciation.

Q. How much depreciation? [71]

A. \$3352.92 out of \$3425.92.

Q. And is there a tax deduction for taxes, State and County taxes? A. There is.

Q. How much is that?

A. Well, the total tax deduction is \$26,533.70.

Q. Would a portion of that apply to the rental properties? A. It would.

Q. Mr. Ware, you testified about your efforts to get finances with which to meet the demands of the Pacific Mutual Company. Were your efforts hampered and embarrassed by the fact that the notes were already over two years in default?

A. Oh, yes, that objection was brought up continually.

Q. Were they hampered also by the fact that the company was in receivership? A. Yes.

Q. What steps, if any, did you take—I will withdraw that question.

As an auditor, are you quite familiar with tax procedure? A. Fairly so.

Q. Income tax procedure, Mr. Ware?

A. Yes. [72]

Q. As a receiver of this company, and in view of your familiarity and experience with income tax matters, what steps or precautions did you take,

(Testimony of Mr. William E. Ware.)

if any, to ascertain whether or not there would be any imposition of an undistributed profits tax in this case.

Mr. Tonjes: That is immaterial, Your Honor. I object to it.

The Member: What do you expect to show, Mr. Witter?

Mr. Witter: I really think it is immaterial, if Your Honor please.

The Member: I will sustain the objection.

Mr. Witter: That is all for the petitioner.

Mr. Tonjes: That is all, Mr. Ware.

The Member: Very well, you are excused.

Witness excused.

The Member: Do you gentlemen wish to submit this case on brief?

Mr. Witter: I would prefer to, Your Honor, I would like to submit a short brief.

The Member: Is that all of your evidence?

Mr. Witter: I think it might be helpful to introduce the return for the year 1937.

Mr. Tonjes: I think it might be, Your Honor.

Mr. Witter: There are some details shown in the [73] return that aren't reflected in that data.

The Member: It will be received as Petitioner's Exhibit No. 9.

(The said document so offered and received in evidence, was marked Petitioner's Exhibit 9, and made a part of this record.)

1937 CORPORATION INCOME AND EXCESS-PROFITS TAX RETURN

UNITED STATES

1937

Internal Revenue Service

(FORM 1120)

7380-33 For Calendar Year 1937 or Fiscal Year 1938
beginning 433 1/2

7380-33
402482

PRIME PLUMBING CORPORATION'S NAME AND ADDRESS

7814 15
3124 1/2
MAR 10 1938
Wm. J. Miller, Jr., Receiver for American Water Co.
600 West Seventh Street - Room 514
Los Angeles - California

PRIME PLUMBING CORPORATION'S NAME AND ADDRESS

Los Angeles - California

Los Angeles - California

Los Angeles - California

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EXCESS-PROFITS TAX COMPUTATION

- Net income for income tax computation (Item 26, Schedule A)
- Share of special stock as declared in your regular stock tax return for the year ended June 30, 1937 (on the basis of the special stock tax return for the year ended June 30, 1938, if your income tax was computed on the basis of the special stock tax return for the year ended June 30, 1938)
- Excess profit 10 percent of Item 2
- Dividend not taxable (see instructions for Item 2)
- Net income for excess-profits tax (Item 26 plus Item 2, but not more than Item 2)
- Amount taxable at 6 percent (12 percent of Item 2, but not more than Item 5)
- Amount taxable at 12 percent (Item 5 minus Item 6)
- Total excess-profits tax

NORMAL TAX COMPUTATION

- Net income for income tax computation (Item 21, Schedule A)
- Dividend received credit (40 percent of Schedule F, column 2)
- Dividends paid credit (for mutual investment companies)
- Dividends subject to normal tax (Item 2 minus Item 10 of 11)
- Tax on portion of Item 12 not in excess of \$10,000 (see instructions for Item 12)
- Tax on portion of Item 12 in excess of \$10,000 and not in excess of \$15,000 (see instructions for Item 12)
- Tax on portion of Item 12 in excess of \$15,000 (see instructions for Item 12)
- Total normal tax (Item 12 plus Item 10 of 11)
- Normal tax on (to be used in lieu of the normal tax on Item 12)
- Insurable companies
- Corporations entitled to the benefits of section 231 of the Revenue Act of 1921
- Corporations organized under the China Trade Act, 1922
- Foreign corporations engaged in trade or business within the United States

UNDISTRIBUTED PROFITS TAX COMPUTATION

- Net income for income tax computation (Item 11, Schedule A)
- Normal tax (Item 12 above)
- Credit for building company affiliate or national mortgage association (see instructions for Item 12)
- Adjusted net income (Item 23 minus Item 24 and 25)
- Dividends paid credit (line 13, Schedule A)
- Credit for contracts restricting dividend payments (see instructions for Item 26)
- Undistributed net income (Item 26 minus Item 27 and 28)
- Portion of Item 29 taxable at 2 1/2% (\$5,000 or 10% of Item 26, whichever is greater (but not more than Item 29))
- Portion of Item 29 taxable at 12 1/2% (10% of Item 26 (if not more than Item 29) minus Item 28)
- Portion of Item 29 taxable at 17 1/2% (20% of Item 26 (if not more than Item 29) minus Item 28)
- Portion of Item 29 taxable at 22 1/2% (20% of Item 26 (if not more than Item 29) minus Item 28)
- Portion of Item 29 taxable at 27 1/2% (Item 29 minus Item 30 to 32)
- Total undistributed profits tax (Item 30 to 34)
- Total normal tax and undistributed profits tax (Item 12 plus Item 34, or Item 18, if Item 12 is zero)
- Less: Credit for income tax of a foreign country or of a possession thereof (see instructions for Item 35)
- Normal tax (Item 36 minus Item 37)
- Excess-profits tax (Item 8 above)
- Total tax due (Item 36 plus Item 38)

NOTE.—One form numbered "DUPLICATE COPY" must be filed with this original return (Item 10 will be returned to taxpayer by mail).

7380-33

7380-33

7380-33

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7380-33

Schedule C

ANALYSIS OF PAID-IN OR CAPITAL SURPLUS

Page 3

1.	Debits to paid-in or capital surplus during the taxable year (to be detailed):	
*	*	*
2.	Paid-in or capital surplus as shown by balance sheet at close of the taxable year (Schedule N)	\$371,872.13
3.	Total	\$371,872.13
4.	Paid-in or capital surplus as shown by balance sheet at close of the preceding taxable year (Schedule N)	\$371,872.13
5.	Credits during the year (to be detailed):	
*	*	*
6.	Total	\$371,872.13

Schedule D-1

COST OF GOODS SOLD

(Where inventories are an income-determining factor)

[Not filled in]

Schedule D-2

COST OF OPERATIONS

(Where inventories are not an income-determining factor)

1.	Salaries and wages	\$	
2.	Other costs (to be detailed):		
	(a) Cost of realized land sales	\$	279.86
*	*	*	*
3.	Total (enter as item 5, Schedule A)	\$	279.86

Schedule E

CAPITAL GAINS AND LOSSES

(From Sales or Exchanges Only)

[Not filled in]

Schedule M

DISTRIBUTIONS TO STOCKHOLDERS AND
DIVIDENDS PAID CREDIT

(See Instruction III)

[Not filled in]

[98]

ARTESIAN WATER COMPANY
Bucks N. - BALTIMORE STREET - One Hundredth St.

1

!VAMON! TEVA KUTIRIR

		Balance Sheet		Statement of Retained Earnings		Statement of Cash Flows	
		Assets	Liabilities	Retained Earnings	Accumulated Depreciation	Net Change in Cash	
ASSETS							
1. Cash		10,150.00		21,567.17			50,835.96
2. Notes receivable		1,150.00					
3. Accounts receivable		2,150.00					
4. Inventory		27,444.10		27,444.10			16,616.82
5. Prepaid expenses							
6. Property, plant, and equipment							
7. Other assets							
8. Total assets		41,694.10		49,011.27			116,862.84
LIABILITIES AND CAPITAL							
9. Accounts payable			1,150.00				
10. Notes payable			2,150.00				
11. Other liabilities			1,150.00				
12. Total liabilities			4,450.00				
13. Common stock			1,150.00				
14. Retained earnings			11,000.00				
15. Total liabilities and equity			17,600.00				
16. Net income				21,567.17			
17. Dividends							
18. Total cash flows				21,567.17			

4.1.4.1.2 CHANGES IN CORPORATION'S OBLIGATIONS AND CAPITAL STOCK (See Instruction 0)

QUESTIONS	QUESTIONS	QUESTIONS	QUESTIONS
1. Total cash receipts during taxable year from sale of corporation's own interest-bearing obligations with original maturity of 1 year or more and original debt			
2. Total cash expenditures during taxable year for purchase or redemption of original debt			
3. Difference between lines 1 and 2			

Schedule M

DISTRIBUTIONS TO STOCKHOLDERS AND
DIVIDENDS PAID CREDIT

(See Instruction III)

[Not filled in]

[98]

1937

UNITED STATES

RETURN OF PERSONAL HOLDING COMPANY

1937

(Addressee's Name)

Treasury Department

(Form 1120-10)

Internal Revenue Service

For Calendar Year 1937 or Fiscal Year

beginning 1937, and ended 1938

REVIEWED

SECTION 8

J. M. WELLS

DATE MAR 9 1938

PRINT PLAINLY COMPLETION NAME AND ADDRESS

William E. Rags, Receiver for Arcticon West Co.

721 West Seventh Street - Room 514

(Street and number)

Los Angeles

(Post office)

California

(State)

Check /

Per Payment

No.

ADJUSTED NET INCOME COMPUTATION UNDER TITLE 1A (See Instructions D)

1. Net income (from Schedule A, line 1) less the Revenue Act of 1918, as amended by the Revenue Act of 1937

2. Add: Contributions or gifts, deduction for computing item 1 (see item 5 below)

3. Excess of expenses and depreciation over income from property not allowable under section 356 (b) (from Schedule A)

4. Total of items 1 to 3

5. Less: Contributions or gifts (from Schedule B) (not to exceed 15% of item 4)

6. Federal income, war-profits, and excess-profits taxes (from Schedule C)

7. Income and profits taxes of a foreign country or United States possession (not deducted in computing item 1)

8. Amount paid in liquidation of liability of the corporation based on liability of a decedent to make contributions or gifts (attach statement, see Instructions B)

9. Total of items 5 to 8

10. Adjusted net income (from item 4) less item 9

11. UNDISTRIBUTED ADJUSTED NET INCOME COMPUTATION (See Instructions D)

12. Less: Dividends paid credit

13. Amount used or irreversibly set aside to pay or retire indebtedness of any kind incurred prior to January 1, 1934 (from Schedule D, line 12)

14. Total of items 12 and 13

15. Undistributed adjusted net income (from 11 minus item 14)

16. Surplus on portion of item 15, not in excess of \$2,000, at 65%

17. Surplus amount of item 15, in excess of \$2,000, at 75%

18. Total surplus in items 16 and 17

19. Total of items 1 to 18

20. Total of items 1 to 18

21. Total of items 1 to 18

22. Total of items 1 to 18

23. Total of items 1 to 18

24. Total of items 1 to 18

25. Total of items 1 to 18

26. Total of items 1 to 18

27. Total of items 1 to 18

28. Total of items 1 to 18

29. Total of items 1 to 18

30. Total of items 1 to 18

31. Total of items 1 to 18

32. Total of items 1 to 18

33. Total of items 1 to 18

34. Total of items 1 to 18

35. Total of items 1 to 18

36. Total of items 1 to 18

37. Total of items 1 to 18

38. Total of items 1 to 18

39. Total of items 1 to 18

40. Total of items 1 to 18

41. Total of items 1 to 18

42. Total of items 1 to 18

43. Total of items 1 to 18

44. Total of items 1 to 18

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51. Total of items 1 to 18

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61. Total of items 1 to 18

62. Total of items 1 to 18

63. Total of items 1 to 18

64. Total of items 1 to 18

65. Total of items 1 to 18

66. Total of items 1 to 18

67. Total of items 1 to 18

68. Total of items 1 to 18

69. Total of items 1 to 18

70. Total of items 1 to 18

WILLIAM E. RAGS, Receiver for Arcticon West Co.

AFFIDAVIT (See Instructions F)

I, the undersigned, president (or vice president or other principal officer) and treasurer (or assistant treasurer or chief accounting officer) of the corporation for which this return is made, being personally duly sworn, make the following statements and certify that this return (including any accompanying schedule) is a true, correct, and complete statement of all the information required by the Revenue Act of 1937, of the person for whom this return is made in good faith for the taxable year pursuant to the Revenue Act of 1936 and 1937 and the Regulations issued thereunder.

Subscribed and sworn to before me this

day of

at

City of

State of

1937.

Notary Public in and for the State of

California

My commission expires on

the day of

1937.

Notary Public in and for the State of

California

My commission expires on

the day of

1937.

Notary Public in and for the State of

California

My commission expires on

the day of

1937.

Notary Public in and for the State of

California

My commission expires on

the day of

1937.

Notary Public in and for the State of

California

(If this return was prepared by some person other than officers or employees of the corporation, the following affidavit must be submitted)

AFFIDAVIT (See Instructions F)

I (we) swear (or affirm) that I (we) prepared this return for the person named herein and that the return (including any accompanying schedule and statement) is a true, correct, and complete statement of all the information required by the Revenue Act of 1937, of the person for whom this return is made in good faith for the taxable year pursuant to the Revenue Act of 1936 and 1937 and the Regulations issued thereunder.

Subscribed and sworn to before me this

day of

at

City of

State of

1937.

Notary Public in and for the State of

California

My commission expires on

the day of

1937.

Notary Public in and for the State of

California

My commission expires on

the day of

NOTE—One true marked "DUPLICATE COPY" must be filed with this original return (\$10 will be assessed if duplicate copy is not filed)

P-119

Q-10

Artestian Water Company

Income Tax Return—Year 1937

Statement re: Exemption Claimed on Undistributed Profits Surtax:

Exemption from undistributed profits surtax is claimed on the following grounds. Attention is respectfully directed to Section 14 of the Revenue Act of 1936, part (d) (2) of which reads:

“(d) Exempt from surtax. The following corporations shall not be subject to the surtax imposed by this Section:

“(2) Domestic corporations which for any portion of the taxable year are in bankruptcy under the laws of the United States, or are insolvent and in receivership in any Court of the United States, or of any State, Territory or the District of Columbia.”

The word “insolvent” was apparently used in its dual sense by Congress. The Senate Finance Committee Report on the Revenue Bill of 1936 of June 1, 1936, on page 15, in discussing Section 14 (d) (2), said:

“The Finance Committee Bill also avoids the possibility of tax avoidance by collusive receiverships by limiting the provision to cases in which the corporation is in bankruptcy under the Federal bankruptcy laws, and to cases in which it is insolvent, i.e., its liabilities are in excess of its assets or it is unable to pay the

claims of creditors as they mature—and in receivership in Federal or State Courts.”

The taxpayer was certainly unable to pay the claims of its creditors as they matured. That is, it was unable to pay them in the usual course of business out of quick assets without selling its capital assets. 32 Corpus Juris 806 states that the word “insolvency” has two meanings:

“In its general and popular meaning, the term denotes the state of one whose entire property and assets, when converted into money without unreasonable haste or sacrifice, are insufficient to pay his debts; * * * But it is frequently used in the more restricted sense to express the inability of a person to pay his debts as they become due in the ordinary course of business.”

Creditors claims, referred to above, which the corporation was unable to pay at maturity, consist of balance due the Pacific Mutual Life Insurance Company on account of money borrowed on November 12, 1929, and represented by two notes, one for \$35,000 and one for \$175,000. The note for \$35,000 carried with it a specific agreement prohibiting the payment of dividends until said note was paid. During 1936 the sum of \$26,750 was paid on this note leaving a balance of \$8,250 which balance was paid during 1937, whereupon the note and collateral agreement were cancelled.

Similarly, during 1937 payments totaling \$74,750 were made on the note for \$175,000, making a grand total of payments made of \$83,000.

The corporation owns subdivision land and oil producing property. The oil land is under lease to Shell Oil Company. The corporation secured its note to the Pacific Mutual Life Insurance Company by a mortgage on its properties, and gave as collateral security an assignment of the oil lease "together with all rents due, or to become due thereunder". The mortgagee notified Shell Oil Co. of the pledge of the lease and rents and instructed Shell Oil Co. to continue to pay the rents and royalties due under the lease to the corporation until further notice. The note and mortgage became due November 30, 1934, and is still past due. It has not been extended or renewed, and will outlaw November 30, 1938. [101]

The corporation has never been in a position to pay off the mortgage out of current assets. From the foregoing, it is apparent, therefore, the corporation was insolvent and in receivership during the taxable year 1937, and is exempt from the surtax under Section 14. [102]

Artesian Water Company
Year 1937

Supplemental Schedule—Item 19—Bad Debts:

Item of \$14,160.00 represents note in principal amount of \$12,000.00 plus interest accrued thereon to December 31, 1935, said interest having been re-

ported as income in 1933, 1934 and 1935, in the sum of \$2,160.00 and was written off in 1937 as a bad debt. The following quotation is from letter of Meserve, Mumper, Hughes & Robertson, attorneys representing the receiver, relative to said note:

“During the year 1937 we instituted the above entitled action for the purpose of collecting that certain promissory note dated December 13, 1934, in the amount of \$12,000 with interest from January 1, 1932, until paid, at the rate of 6% per annum, payable semi-annually, in favor of Artesian Water Co. and signed by Maclay Rancho Water Co. by M. K. Rindge, President and P. D. Gowen, Secretary. We have been unable to effect any collection whatsoever on account of the judgment obtained in the above action. In fact, we have not even been able to recover costs expended in recovering the judgment. In our opinion, the judgment is, and at all times has been, valueless, and you are entitled to write off the note sued on as a loss for the year 1937.”

A statement of the financial condition as of September 30, 1937 of the Maclay Rancho Water Co., prepared by its bookkeeper, disclosed the fact that, in the event of disposition at fair market values of its assets, it would not be possible to realize a sum sufficient to pay off the company's bonded indebtedness. [103]

Schedule A

EXCESS OF EXPENSES AND DEPRECIATION OVER
INCOME FROM PROPERTY NOT DEDUCTIBLE
UNDER SECTION 356

[Not filled in]

Schedule B

CONTRIBUTIONS OR GIFTS

[Not filled in]

Schedule C

FEDERAL INCOME, WAR-PROFITS, AND
EXCESS-PROFITS TAXES

Nature of Tax	Taxable Year	Amount
Federal Income Tax—Normal.....	1936	\$4,145.91
Federal Excess Profits.....	1936	617.82
Federal Surtax on Und. Profits.....	1936	263.60
Total (enter as item 6, first page).....		\$5,027.33

Schedule D

AMOUNTS USED OR SET ASIDE TO PAY OR RETIRE
INDEBTEDNESS INCURRED PRIOR TO JANUARY
1, 1934

I

- Description of indebtedness.....Mortgage Note
- Date incurred or assumed.....November 12, 1929
- Date dueNovember 30, 1934
- Original amount of indebtedness.....\$210,000.00
- Amount used or set aside prior to January 1,
1934, to pay or retire such indebtedness.....
- Excess of indebtedness on January 1, 1934, over
total amount used or set aside prior to that
date to pay or retire such indebtedness.....\$210,000.00

the plan for payment or retirement of the obligations, indicating date and method of adoption, and where the plan is covered by a mandatory sinking fund agreement or similar arrangement, submit a copy of the indenture or agreement by which the fund was established and under which it is maintained—See attached statement.

If the amount claimed as a deduction in item 13, first page of this return, represents an amount irrevocably set aside to pay or retire the indebtedness, explain fully the circumstances and method by which it was irrevocably set aside.

[105]

Artesian Water Company
Personal Holding Company Return
Year 1937

Statement re: Item 13 (from Schedule D)
Amounts Used to Pay Indebtedness Incurred Prior
to January 1, 1934:

The indebtedness consists of note secured by mortgage given to Pacific Mutual Life Insurance Co. The note and mortgage became due November 30, 1934 and is still past due. It has not been extended or renewed and will outlaw November 30, 1938. The mortgage includes oil land under lease to Shell Oil Company and other acreage and is further secured by the assignment of existing leases which constitute the corporation's chief source of income. The mortgagee notified Shell Oil Co. of the pledge of the lease and rents, and instructed the Shell Oil Co. to continue to pay the rents and royalties due under the lease to the corporation until further notice.

As a result of numerous discussions with the mortgagee relative to the payment of the indebtedness the receiver tendered to the mortgagee and the mortgagee accepted payments of \$2,750 per month on the principal, in addition thereto sums totaling \$50,000.00 were paid and accepted during 1937. This procedure followed an expressed intention of the mortgagee to collect from the lessee the royalties from the oil lease, or to foreclose. The payments on principal during 1937 totaled \$83,000.00, and same were made with the approval and by authorization of the Superior Court of the State of California, which has jurisdiction over the corporation's receivership.

The mortgagee has formally refused to extend or renew the mortgage. At the present time the indebtedness is past due and subject to possible action by the mortgagee. The mortgage cannot be refinanced while the corporation is in receivership, as no one will take a note or mortgage signed by the receiver.

The payment of \$83,000.00 in 1937 was reasonable, considering the size and terms of the mortgage, and considering also that the oil royalties were pledged to the mortgagee, and that the pledgee was entitled to take the royalties to apply on interest and principal (Section 2989 of the California Civil Code, 21 Cal. Jur. 312, 14 C. J. 822). Consideration should also be given to the fact that the corporation was in receivership and the court authorized these payments. [106]

1937 RETURN OF CAPITAL-STOCK TAX

For Year Ending June 30, 1937

Domestic Corporations

(Sec. 105, Revenue Act of 1935, as amended by Sec. 401 of the Revenue Act of 1936)

This return must be filed, in triplicate, and received by the Collector of Internal Revenue for your district on or before July 31, 1937. The tax must be paid on or before that date.

1. Name—William E. Ware, Receiver for Artesian Water Company.

2. Address—727 West Seventh Street, Los Angeles, California.

3. Name of parent company, if any.....
(District filed)

4. Name of subsidiary, if any.....
No. shares held..... (District filed)

5. Nature of business in detail—Land Owners.

6. Incorporated or organized in State of California. Month April Day 23rd Year 1900.

7. Was a capital-stock tax return filed for the preceding taxable year ended June 30, 1936? Yes. If filed under a different name, state the name.....
(District filed)

8. Date of close of last income-tax taxable year ended on or prior to June 30, 1937, or, if newly organized corporation having no income-tax taxable year ended on or prior to June 30, 1937, date of organization.....

Corporation making an original declaration of value upon this return must enter the amount of such declared value in item 9. This block is not to be used by a corporation which established its original declared value by the first return for the year ended June 30, 1936.

9. Original declared value of entire capital stock.....\$.....

(The value declared must be definite and unqualified. A value must be declared in every case regardless of whether exemption from the tax is claimed. See instructions 1 and 3)

Corporations which have established their original declared value by the return for the year ended June 30, 1936, must adjust such declared value as provided for in Schedule I on page 2 of this return and then enter the amount of the adjusted declared value in item 10.

10. Adjusted declared value of entire capital stock (Last item of Schedule I, page 2)....\$310,944.44

11. Exemptions.—The Act provides for an exemption from the tax only on the grounds indicated below. Corporations claiming exemption must (1) report a value for the capital stock under item 9 or 10, (2) check the appropriate block below, showing the basis of the claim, and (3) submit with the return a full statement of the evidence specified under the block checked.

☐ Corporation exempt from income tax under section 101, Revenue Act of 1936. (1) State under which subsection of section 101 (2) Furnish information required by instruction 14.

- ☐ Insurance company subject to tax under section 201, 204, or 207, Revenue Act of 1936. State which section.....
- ☐ Corporation not doing business. (1) Furnish information required by instruction 16. (2) Report value of capital stock in item 9 or 10 above.

Computation of Tax	For Use of Taxpayer	For Use of Department
12. Amount reported in item 9 or 10.....	\$310,944.44	\$.....
13. Tax at rate of \$1 for each full \$1,000 in item 12 (omit cents).....	Exempt	XXXX
14. Penalty of percent for delinquency in filing return .....	.....	.....
15. Interest at 6% per annum beginning August 1, 1937 .....	.....	.....
16. Total tax, penalty, and interest.....	.....	.....

I, the undersigned William E. Ware, Receiver for Artesian Water Co. and,
, of the corporation for which this return is made, being severally duly sworn, each for himself deposes and says that this return, including any accompanying schedules and statements, has been examined by him and is, to the best of his knowledge and belief, a true and complete return, made in good faith, for the taxable year stated, pursuant to the Revenue Act of 1935, as amended, and the Regulations issued thereunder.

Sworn to and subscribed before me this.....day
of, 193.....

[Corporate	WILLIAM E. WARE
Seal]	Receiver
[Notarial	.....
Seal]	.....

[Exemption allowed. Jan. 8, 1938. JMB]

[107]

Page 4

The schedules on this page must be filled in by every corporation making adjustments to an original declared value for the capital stock established by the return for the year ended June 30, 1936. See instructions 5 to 9, inclusive.

**SCHEDULE I. ADJUSTMENT OF ORIGINAL DECLARED VALUE
OF ENTIRE CAPITAL STOCK FOR ALL TRANSACTIONS DUR-
ING THE INCOME-TAX TAXABLE YEAR ENDED DECEMBER
31, 1936.**

Original declared value as established by the first return for
the taxable year ended June 30, 1936.....\$250,000.00

Additions:

- | | |
|--|-----------|
| (1) (a) Total cash paid in for stock or
shares (see instruction 7, item 1).....\$ | — |
| (b) Fair market value of all property
received for stock or shares (see
instruction 7, item 1)..... | — |
| (2) Paid-in surplus and contributions to
capital (see instruction 7, item 2)..... | — |
| (3) Net income (see instruction 7, item 3) | 34,679.23 |
| (4) Excess of income wholly exempt from
tax over amount disallowed as deduc-
tions by section 24 (a) (5) of the Rev-
enue Act of 1934 or 1936 (see instruc-
tion 7, item 4)..... | 26,265.21 |

- (5) Dividend deduction allowable for income-tax purposes (see instruction 7, item 5)

—

Total additions 60,944.44

Total Before Deductions..... \$.....

Deductions:

- (A) (1) Total cash distributed in liquidation to shareholders (see instruction 7, item A)\$ —

- (2) Fair market value of all property distributed in liquidation to shareholders (see instruction 7, item A) —

- (B) Distributions of earnings or profits (see instruction 7, item B)..... —

- (C) Excess of deductions allowable over gross income and claimed on income-tax return (see instruction 7, item C)..... —

Total deductions —

Adjusted Declared Value (enter in item 10, page 1)..... \$310,944.44

SCHEDULE II. ANALYSIS OF CHANGES IN CAPITAL STOCK AND SURPLUS

Capital Stock and Surplus at beginning of year

1. Capital stock: Preferred.....
Common.....\$612,220.00

2. Capital or paid-in surplus.....

3. Surplus reserves.....

4. Surplus and undivided profits..... 264,431.87

Additions—Capital transactions

5. Total cash and fair market value of property paid in for stock or shares (total of items 1(a) and 1(b), Schedule I)*

6. Paid-in surplus and contributions to capital (item 2, Schedule I)*.....	.....
7. Other additions (to be detailed).....	.....
Additions—Revenue transactions	
8. Net income (item 3, Schedule I).....	34,679.23
9. Income wholly exempt from income tax. (This total less the amount entered as item 17 of this schedule should correspond with item 4, Schedule I) (See instruction 7, item 4)	26,265.21
10. The amount of the dividend deduction allowable for income-tax purposes (item 5, Schedule I) (see instruction 7, item 5).....	.....
11. Other additions (to be detailed).....	.....
Sign space rental (1934-5).....	146.63
1936 Excess Profits tax.....	617.82
<hr/>	
Total.....	\$938,360.76

Deductions—Capital transactions

12. Liquidating distributions (total of items A(1) and A(2), Schedule I)*.....	.....
13. Other distributions (item B, Schedule I)*.....	.....
14. Enter class and amount of distributions in corporation's own stock:	
.....\$.....	x x x x x
15. Other deductions (to be detailed).....	.....

Deductions—Revenue transactions

16. Excess of deductions allowable over gross income and claimed on income-tax return (item C, Schedule I).....	.....
17. Deductions disallowed by sec. 24(a)(5), 1934 or 1936 Act. (See item 9 of this schedule)...	.....
18. Other deductions (to be detailed).....	.....
Taxes paid (for prior yrs).....	4,149.34
Street bonds (for prior yrs).....	76.74
1935 Income tax.....	614.52

Capital Stock and Surplus at end of year

19. Capital stock: Preferred.....	.....
Common.....	612,220.00
20. Capital or paid-in surplus.....	.....
21. Surplus reserves .....	.....
22. Surplus and undivided profits.....	321,300.16
Total.....	<u>\$938,360.76</u>

*Enter values shown by the books if different from values entered in Schedule I and explain difference.

[108]

Mr. Tonjes: With permission to withdraw the original and substitute a photostat.

The Member: Yes. Permission will be granted to substitute a photostat.

The Clerk: Let the record show that counsel for the respondent is withdrawing Petitioner's Exhibit No. 9, the income tax return, for the purpose of making a photostatic copy.

The Member: Do you desire that the time for the filing of briefs be fixed at forty-five days as provided by the rules, or do you wish a different time?

Mr. Witter: That time is satisfactory to me.

Mr. Tonjes: I believe that will be satisfactory.

If Your Honor please, I am wondering in view of the fact that Mr. Witter desires to point out some of the local law and its applicability, whether it might not be more helpful to have Mr. Witter file an opening brief and I will file a reply brief, giving

[Title of Board and Cause.]

CERTIFICATE

I, B. D. Gamble, Clerk of the U. S. Board of Tax Appeals, do hereby certify that the foregoing pages, 1 to 110, inclusive, contain and are a true copy of the transcript of record, papers, and proceedings on file and of record in my office as called for by the Praeceptum in the appeal (or appeals) as above numbered and entitled.

In testimony whereof, I hereunto set my hand and affix the seal of the United States Board of Tax Appeals, at Washington, in the District of Columbia, this 1st day of May, 1941.

[Seal]

B. D. GAMBLE,

Clerk,

United States Board of Tax Appeals.

[Endorsed]: No. 9824. United States Circuit Court of Appeals for the Ninth Circuit. Artesian Water Company, a corporation, Petitioner, vs. Commissioner of Internal Revenue, Respondent. Transcript of the Record. Upon Petition to Review a Decision of the United States Board of Tax Appeals.

Filed May 16, 1941.

PAUL P. O'BRIEN,

Clerk of the United States Circuit Court of Appeals
for the Ninth Circuit.

In the United States Circuit Court of Appeals
for the Ninth Circuit

U. S. C. C. A. No. 9824

Docket No. 100824

ARTESIAN WATER COMPANY, a corporation,
Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

To the Clerk of the Circuit Court of Appeals:

Petitioner hereby assigns the following errors
and designates the entire record for printing:

ASSIGNMENT OF ERRORS ON APPEAL

(1) The Board erred in holding that the Petitioner was subject to surtax under Section 14 of the Revenue Act of 1936 for not distributing its profits in the year 1937.

(2) The Board erred in not finding as a fact, and holding as a matter of law, that the Petitioner was in receivership and insolvent during 1937, or a portion thereof, and, therefore, under the provisions of Section 14 (d)(2) of the Revenue Act of 1936, not subject to surtax imposed by Section 14 (b) of that Act.

(3) The Board erred in not finding as a fact, and holding as a matter of law, that the mortgages of Petitioner's income producing assets and the assignment of its leases, under the circumstances and commitments existing in the taxable year, did con-

stitute a contract restricting it from the payment of dividends within the meaning of Section 26 (c)(1) of the Revenue Act of 1936.

(4) The Board erred in not finding as a fact, and holding as a matter of law, that the mortgages of Petitioner's income producing assets and assignment of Petitioner's leases, under the circumstances and commitments existing in the taxable year, did constitute a requirement that the Petitioner pay on, or set aside for payment on, its indebtedness, its earnings and profits of the taxable year and, therefore, rendering it exempt from surtax under the specific provisions of Section 14 (c)(2) of the Revenue Act of 1936.

(5) The Board erred in holding that the Statutes of California prohibiting Petitioner from declaring a dividend while it was unable to pay its debts, did not constitute a contract exempting the Petitioner from surtax on undistributed profits under the provisions of Section 26 (c)(1) and (2) of the Revenue Act of 1936.

DESIGNATION OF PORTIONS OF THE RECORD

The Petitioner desires that the entire certified transcript be printed for the record on appeal.

GEORGE G. WITTER

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Los Angeles, California

Attorney for Petitioner

[Endorsed]: Filed May 21, 1941. Paul P.
O'Brien, Clerk.

No. 9824.

IN THE

5

United States Circuit Court of Appeals
FOR THE NINTH CIRCUIT

ARTESIAN WATER COMPANY, a corporation,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

BRIEF FOR APPELLANT.

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FILED

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TOPICAL INDEX.

PAGE

Statement of pleadings and jurisdiction.....	1
Statement of the case.....	2
Assignment of errors.....	4
Summary of argument.....	5
Argument	6

I.

The petitioner was in receivership and insolvent in the taxable year	6
--	---

II.

The petitioner's promissory note, combined with the assignment of its lease and the income therefrom, constituted a contract restricting payment of dividends and disposing of the earnings of the taxable year within the meaning of section 26 (c) (1) and (2) of the Revenue Act of 1936.....	17
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June 11, 1940. On January 22, 1941, the Board handed down its findings of fact and opinion and entered its final order in the appeal [Tr. pp. 21-37].

On April 16, 1940, the petitioner filed its petition for review by the United States Circuit Court of Appeals (Ninth Circuit) [Tr. p. 38], and duly completed the filing of said petition by service of a copy thereof and a praecipe upon counsel for the respondent [Tr. p. 132], proof of which service is on file with the clerk of this Honorable Court.

Statement of the Case.

The only question in this case is whether the petitioner should be subjected to the undistributed profits tax (Revenue Act of 1936, Section 14) for not having distributed its income to its stockholders in the calendar year 1937.

Briefly stated, the facts are:

The petitioner, a California corporation, was an owner of lands. In 1929 it gave its note for \$175,000.00 to the Pacific Mutual Life Insurance Company to cover indebtedness owed to that company. It secured this note by a mortgage on all its income-producing assets [Tr. p. 77] and, as additional security, petitioner assigned to the insurance company its lease with Shell Oil Company and all the income therefrom [Tr. p. 24]. The latter income from oil constituted over 90 per cent of petitioner's total income [Tr. p. 24]. In 1931 petitioner gave the insurance company an additional note for \$35,000.00, which note was not subjected to the prior mortgage and assignment, but, with respect to this note, the petitioner agreed not to declare dividends until it was paid.

Both of these notes matured on November 12, 1934. Nothing was paid on the principal of either note at maturity. Petitioner requested extension of time, but was refused [Tr. p. 84].

In 1935 the petitioner was placed in involuntary receivership, not by its own creditors but by a creditor of one of its stockholders. The receivership continued until 1939, when petitioner was discharged.

As soon as appointed the receiver started negotiations with the insurance company for an extension of time within which to pay the two notes above mentioned. After several refusals, the receiver was finally given an informal extension to March 3, 1937, provided certain payments were made each month in the interim. The receiver was notified in writing at this time, however, that no extension would be granted beyond March 2, 1941, and that the insurance company would expect payment to be made in full not later than that date. The receiver made strenuous and determined efforts to refinance the notes. He negotiated with many banks and brokers, but without success.

Unable to refinance, the receiver paid such amounts as he could. In 1936 he paid \$26,750.00, all of which was applied on the second note. In 1937 the receiver paid a total of \$83,000.00, \$8,250.00 of which paid the balance owing on the second note, and the remainder, or \$74,750.00, was applied on the first note. Every payment was made pursuant to the instruction and order of the Superior Court. In the taxable year 1937 petitioner paid its entire net income on the notes, plus approximately \$30,000.00 out of its depletion reserves. At the close

of the taxable year petitioner still owed a balance of \$100,250.00, which, at the time, it was wholly unable to pay.

The petitioner filed its income tax return for 1937 and paid a normal income tax of \$6,955.17. The Commissioner found the income stated in the return correct and the normal tax paid correct, but imposed on the petitioner a surtax of \$7,380.33 for not having distributed its income to its stockholders. In asserting such surtax, under Section 14 of the Revenue Act of 1936, Commissioner allowed as a credit the \$8,250.00 paid in 1937 on the second note, but refused to allow any credit for amounts paid on the first note.

Assignment of Errors.

(1) The Board erred in holding that the petitioner was subject to surtax under Section 14 of the Revenue Act of 1936 for not distributing its profits to its stockholders in the year 1937.

(2) The Board erred in not finding as a fact, and holding as a matter of law, that the petitioner was in receivership and insolvent during 1937, or a portion thereof, and, therefore, under the provisions of Section 14(d)(2) of the Revenue Act of 1936, not subject to surtax imposed by Section 14(b) of that Act.

(3) The Board erred in not finding as a fact, and holding as a matter of law, that the mortgages of petitioner's income producing assets and the assignment of its leases and income, under the circumstances and commitments existing in the taxable year, did constitute a contract restricting it from the payment of dividends within the meaning of Section 26(c)(1) of the Revenue Act of 1936.

(4) The Board erred in not finding as a fact, and holding as a matter of law, that the mortgages of petitioner's income producing assets and assignment of petitioner's leases and income, under the circumstances and commitments existing in the taxable year, did constitute a requirement that the petitioner pay on, or set aside for payment on, its indebtedness, its earnings and profits of the taxable year and, therefore, render it exempt from surtax under the specific provisions of Section 14 (c) (2) of the Revenue Act of 1936 to the extent such earnings were so applied.

Summary of Argument.

The petitioner was in receivership and insolvent in the year 1937 and therefore, under Section 14(d)(2), not subject to undistributed profits tax. By the word "insolvent", Congress meant "unable to pay the claims of creditors as they mature."

Long prior to the taxable year the petitioner had assigned its oil lease and all income therefrom to its creditor, the Pacific Mutual Life Insurance Company. Such assignment under California laws, which is controlling, passes full title in such income to the creditor. Income so assigned was no longer available to the petitioner for the declaration of dividends. Such assignment constitutes a contract, expressly restricting the payment of dividends and expressly making disposition of the earnings and profits within the meaning of Section 26(c)(1) and (2) of the Revenue Act of 1936. As petitioner's entire income was applied in partial payment of its debt, it is entitled to credit against undistributed profits tax for the entire amount of the same under Section 26(c)(1) and (2).

ARGUMENT.

I.

The Petitioner Was in Receivership and Insolvent in the Taxable Year.

Section 14(d)(2) of the Revenue Act of 1936 provides as follows:

“(d) EXEMPTION FROM SURTAX.—The following corporations shall not be subject to the surtax imposed by this section:

* * * * *

“(2) Domestic corporations which for any portion of the taxable year are in bankruptcy under the laws of the United States, or are insolvent and in receivership in any court of the United States or of any State, Territory, or the District of Columbia.

* * * * *

There is no question about the receivership, so we pass to the question of insolvency.

The word “insolvent” is a flexible term that has been given various meanings, sometimes by statute, and often by the courts in varying situations. I have no doubt if the word “insolvent” had merely been inserted in Section 14(d)(2) and no definition left by Congress, that the courts, with an eye to the essential nature of the undistributed profits tax and its potential harshness in operation, would have given the term its most liberal meaning. But conscious perhaps of the several meanings attached to the word “insolvent”, the Senate Finance Committee, who inserted the word into the Act, also defined the meaning it was to carry. The following is an extract from the report of the Senate Finance Committee on the Revenue Bill of 1936, found on page 15 of that report, dated

June 1, 1936. In discussing Section 14(d)(2), the chairman said:

“Section 105 of the House Bill exempted domestic corporations in bankruptcy or receivership from the undistributed-profits tax in that bill and subjected them to a flat 15 per cent rate of tax. The bill as reported (section 14(c)(2)) similarly exempts such corporations from the 7 per cent undistributed-profits surtax and applies to them the graduated rates applicable to other corporations. The committee proposal specifically exempts the corporation in this situation from the undistributed-profit surtax for its entire taxable year even if it is bankrupt or in receivership for only a part of the taxable year. This proposal is founded on the principle that if a corporation goes into bankruptcy or receivership after its taxable year has started, it is so weak that an undistributed-profits surtax ought not to be or can not be imposed upon it. Similarly, if it comes out of bankruptcy or receivership during its taxable year, it should be allowed to operate free of such tax during the remainder of the year in order to recover its strength. The Finance Committee bill also avoids the possibility of tax avoidance by collusive receiverships by limiting the provision to cases in which the corporation is in bankruptcy under the Federal bankruptcy laws, and to cases in which it is insolvent—i. e., its liabilities are in excess of its assets or it is unable to pay the claims of creditors as they mature—and in receivership in Federal or State courts.”

The report, we believe, evidences three things:

(1) That the word “insolvent” was added to prevent collusive receiverships instigated to evade tax. There is no question of collusion here because the receivership was

instituted in 1935, before an undistributed profits tax was even discussed.

(2) That Congress recognized the potential harshness of the tax and sought to safeguard a company in a weakened financial condition against its operation.

(3) That the word "insolvent" means a taxpayer unable to pay its debts as they mature.

The Government argued below that the statute intends that the receivership shall be instituted *on the ground of* insolvency. If the Board did not actually acquiesce in this position, it, at least, emphasized it greatly in its opinion. We find no such requirement in the statute. The statute merely requires that the two conditions be concurrent, that is, that the taxpayer be *in receivership* and *insolvent* at the same time and at sometime during the taxable year. A taxpayer who is laboring under those two conditions is in just as bad a position, regardless of how he was placed into receivership. All of the reasoning that urges the relief from the tax in the case of one, urges it in the case of the other. We see no ground for the distinction either in the wording of the statute, or outside the statute.

The evidence in this case shows beyond any reasonable doubt that this petitioner was unable to pay its matured and past due debts in the year 1937. It is the petitioner's contention that when this is shown, it matters not if its assets under normal conditions were in excess of its liabilities (see cases cited below on this point), and it matters not if its inability to pay its debts was due in part, or in whole, to the fact that it was in receivership. The solvency or insolvency of the petitioner, that is, its ability to pay its debts, must be determined in the actual situation in which the petition is found in the taxable year and

not in some false and assumed situation in which it is not found, for example, free from receivership.

Passing to a review of the evidence and findings, we find the following:

(1) Immediately upon his appointment, the receiver began negotiations to obtain an extension of the loans. [Board's Findings of Fact, Tr. p. 26.]

(2) The conservator appointed for the Pacific Mutual Life Insurance Company in 1936 disapproved the loans and refused any extension of time. [Board's Findings of Fact, Tr. p. 27.]

(3) The receiver then attempted to refinance the loans but was unsuccessful. [Board's Findings of Fact, Tr. p. 26.]

(4) In his efforts to refinance the loans the receiver negotiated with the loaning officers of the California Bank, Security-First National Trust & Savings Bank, and two or three other banks in town, with the idea of attempting to procure a new loan. All of the negotiations fell through, due to the fact that none of the loaning officers felt they could make a new loan signed by the receiver. The title companies would not issue satisfactory title. [Rec's Test, Tr. p. 97.] The negotiations failed, also, because the value of the properties was more or less unknown. The Security Bank spent considerable time in appraising the properties but declined the loan. [Rec's Test, Tr. p. 98.] The receiver's efforts to refinance were also hampered and embarrassed because of the fact that the notes were already two years in default. That objection was brought up continually. [Rec's Test, Tr. p. 104.]

The receiver's testimony and the Board's findings show without any doubt that in 1937 this petitioner was in a

Russell etc. Co. v. E. C. Faitonta Hdw. Co. (N. J. Ch.), 62 Atl. 421;

Baker v. Emerson, 4 App. Div. 348, 38 N. Y. 5576;

Thompson v. Thompson, 4 Cush. (Mass.) 127, 134.

Section 3450, Civil Code of California:

“A debtor is insolvent, within the meaning of this title, when he is unable to pay his debts from his own means as they become due.”

Sam Ramazzina et al., Co-partners Under the Firm Name and Style of Ramazzina Brothers, an Insolvent Debtor, 110 Cal. 488:

“* * *

“It is also insisted that the co-partnership of Ramazzina Brothers was not insolvent at the time of the filing of said petition, as shown by a comparison of its assets and liabilities appearing therein. While it does appear therefrom that the valuation of the partnership assets exceeds considerably the liabilities of the partnership, yet the petition further discloses that the partners individually are hopelessly insolvent. The petitioners further allege directly that they are insolvent, and the mere fact that the assets in value exceed their liabilities does not prove solvency. Such fact might exist, and often does exist, and still a debtor be entirely insolvent within the purview of the Insolvent Act. * * *.”

First National Bank of Silverton v. E. J. Walton, 5 L. R. A. 765, Colorado Supreme Court:

“By insolvency is meant an inability to fulfill one’s obligations according to his undertaking, and general

inability to answer in court for all of one's liabilities existing and capable of being enforced; not an absolute inability to pay at some future time, upon a settlement and ending up of a trade, but as not being in condition to pay one's debts in the ordinary course, as persons carrying on trade usually do."

Alpha Hardware & Supply Co. v. Ruby Mines Co., Cal. App. 97, Whiting 1929, p. 515:

"(7) A debtor is insolvent when he is unable to pay his debts from his own means as they become due. *Southwick v. Moore*, 61 Cal. App. 585 (215 Pac. 704); *First National Bank of Los Angeles v. Maxwell*, 123 Cal. 360 (69 Am. St. Rep. 64, 55 Pac. 980)."

32 *Corpus Juris* 806, states that the word "insolvency" has two meanings:

"In its general and popular meaning the term denotes the state of one whose entire property and assets, when converted into money without unreasonable haste or sacrifice, are insufficient to pay his debts; * * * But it is frequently used in the more restricted sense to express the inability of a person to pay his debts as they become due in the ordinary course of business."

This petitioner in 1937 was not only unable to pay its debts in the ordinary course of business, but was unable to pay them by hypothecating and pledging all of its assets and income. Congress certainly intended to afford relief to a taxpayer so placed when it said "in receivership and insolvent" and then defined "insolvent" to mean "unable to pay claims of creditors as they mature." With such language in the act, Congress should

not be held to have intended to impose a surtax on a company situated as was this petitioner for *not* doing what, in the first place, *it couldn't do* and what, in the second place, *it sholdn't do*, that is, distribute its income to its own stockholders. I say "couldn't do" because it was entirely under the jurisdiction of the Superior Court and payment of its entire income to its creditors was made on instruction and order of the Court. I say "couldn't do" also because no court in California would permit distribution of profits to stockholders under such circumstances. The California codes, in fact, prohibit and make quasi-criminal declaration of dividends under such circumstances. In addition, the entire income had been assigned to the creditor and belonged to the creditor, as will be shown later in this brief. I say "shouldn't do" from every standpoint, moral, legal, equitable and financial, for reasons that are obvious. The company did the only thing it could and should do—it paid its entire net income to its creditor. After doing so, it still had an indebtedness of \$100,250.00, which it had no means within its power at that time to liquidate.

The statute we are here discussing has been repealed. It was too harsh, even in a day of unparalleled harshness in revenue laws. Effect must be given to the words of the statute for the short period in which it still remains effective. But the statute should not be extended beyond its necessary implications. We feel that is what the Board of Tax Appeals has done in this case. Congress never intended to penalize a company in the

position of this petitioner in the year 1937 for not distributing its net income to its own stockholders, and there is ample basis in the language of the act itself to sustain that statement. A number of cases defining insolvency and applying a definition to varying situations have been shown above, but no better definition can be found than the one the Finance Committee itself gave. It is in full accord with the definition long ago given by the Supreme Court of the United States in *Cunningham v. Norton*, 125 U. S. 77, wherein Mr. Justice Bradley said:

“Secondly: It is objected that the deed of assignment does not, on its face, show that the assignor was insolvent, or in contemplation of insolvency. The obvious answer is that if this is a necessary requirement, the deed does state that the assignor ‘is indebted to divers persons in considerable sums of money, which he is at present unable to pay in full.’ When a person is unable to pay his debts, he is understood to be insolvent. It is difficult to give a more accurate definition of insolvency. The objection is without foundation.”

The Board apparently based its holding against petitioner as to insolvency on three grounds, viz:

1. The receivership was not instituted on the ground of insolvency [Tr. pp. 31 and 33].
2. Book value of assets greatly exceeded liabilities [Tr. p. 33].
3. Petitioner had a net income of \$54,101.14 for 1937.

We have already mentioned our reasons for believing the statute does not require the first. If the definition of insolvency given by the Senate Finance Committee be accepted, the second ground is immaterial. The authorities and cases cited so hold, even when *actual* value of assets be considered. But here the Board is considering mere book values, which in this instance are write-up values as of March 1, 1913 [Tr. p. 100]. Values were lower in 1937 than in 1913 [Tr. pp. 100, 101]. No oil depletion had ever been charged against assets on the books [Tr. pp. 94, 95]. The *book* values on which the Board relied are generally discredited by receiver's efforts to raise money without success, and specifically so by the fact that the Security Bank spent considerable time in appraising the assets of the company and then declined to make a loan [Tr. p. 98].

As to the third ground, the statute requires only that at some portion of the taxable year the taxpayer be in receivership and insolvent. Looking at the picture at the beginning of the year, as we are entitled to do, we have a balance owing of \$185,000.00 and already an operating deficit of \$50,571.97, which deficit would be greatly increased if depletion were charged to surplus, as it should be. Judging by the amounts the receiver, under pressure, had been able to pay to the insurance company during 1935 and 1936, viz., nothing in 1935 and \$26,750.00 in 1936, the prospects of petitioner paying its debts then or by March 2, 1937, or at any time in the immediate future, were nil. When to this picture is added the fruitless efforts of the receiver to raise money with which to pay debts, the insolvency of the petitioner, within the meaning intended by Congress, is well established.

II.

The Petitioner's Promissory Note, Combined With the Assignment of Its Lease and the Income Therefrom, Constituted a Contract Restricting Payment of Dividends and Disposing of the Earnings of the Taxable Year Within the Meaning of Section 26 (c) (1) and (2) of the Revenue Act of 1936.

The pertinent portion of Sections 26(c)(1) and 26(c)(2) are set out below:

"SEC. 26. CREDITS OF CORPORATIONS.

"In the case of a corporation the following credits shall be allowed to the extent provided in the various sections imposing tax—

* * * * *

"(c) * * *

"(1) * * *. An amount equal to the excess of the adjusted net income over the aggregate of the amounts which can be distributed within the taxable year as dividends without violating a provision of a written contract executed by the corporation prior to May 1, 1936, which provision expressly deals with the payment of dividends.

* * * * *

"(2) * * *. An amount equal to the portion of the earnings and profits of the taxable year which is required (by a provision of a written contract executed by the corporation prior to May 1, 1936, which provision expressly deals with the disposition of earnings and profits of the taxable year) to be paid within the taxable year in discharge of a debt, or to be irrevocably set aside within the taxable year for the discharge of a debt; to the extent that such amount has been so paid or set aside."

a chattel mortgage, which conveys the thing mortgaged, with power to collect, hires and to use the chattel until the money secured thereby is paid; and, until payment is proved, all the right of the mortgagor to the mortgaged property passes to the mortgagee.”

Change of possession is not essential to validity:

3 *Cal. Jur.*, p. 204:

Things in action expressly exempted under the code from statutory rule requiring a valid transfer of personal property to be followed by immediate delivery and change of possession, in order to make transfer valid (Civil Code Cal., Sec. 3440). So where an assignment is absolute in its terms and conveys a personal interest in the written evidence of the chose in action, it is complete, and TITLE THERETO IS VESTED in assignee notwithstanding that possession and control of the chose in action are retained by the assignor.

If the assignee becomes the owner of income so assigned, as the above cases and authorities demonstrate, by what theory can the assignee declare a dividend out of such income? It is true for the purpose of normal income tax the income is still technically the income of the assignor and properly taxable to the assignor, because though he should never possess the income, it is being applied for his benefit. But to impose a surtax because the assignor does not declare a dividend out of such assigned income, which is no longer his, is quite a different matter and one that obviously should not be indulged in if any reasonable interpretation of the law permits other treatment.

Discussing Section 26 (c) (1) first, the Board in its Opinion said [Tr. p. 35]:

“There is nothing to show that the assignment of the Shell Co. oil royalties by petitioner to its creditor, the Pacific Mutual Insurance Co., as further security for the payment of its \$175,000 note, in any manner expressly restricted petitioner in the payment of dividends. This assignment is not in evidence and we do not know what written provisions it contained, but the witness who testified in regard to it did not say that the assignment dealt ‘expressly with the payment of dividends.’ Petitioner does not so contend in its brief. It simply contends that because petitioner had assigned these oil royalties to its creditor, as additional security for the payment of its notes, it was by necessary implication prohibited from the payment of any dividends during the effective period of the assignment.”

The Board decided this case soon after the Supreme Court handed down its opinion in *Helvering v. Northwest Steel Rolling Mills, Inc.*, 311 U. S. 46. The Board was doubtless influenced and guided, as it should be, by that decision. But we do not understand the Court’s language in that case to go so far as to hold that a specific contract expressly assigning title to income out of which dividends might be declared was not a contract dealing expressly with the declaration of a dividend. In the *Northwest Steel Rolling Mills, Inc.*, case the Supreme Court was dealing with statutorily prohibited dividends and it said:

“The natural impression conveyed by the words ‘written contract executed by the corporation’ is that an explicit understanding has been reached, reduced to writing, signed and delivered.”

- (3) The amount of earnings sought as a credit was “required . . . to be irrevocably set aside within the taxable year for the discharge of a debt. The assignment of the earnings constituted an irrevocable setting aside and for no purpose other than “for the discharge of a debt.”
- (4) “. . . to the extent that such amount has been so paid or set aside.” The entire royalty earnings were both set aside and paid on the debt within the taxable year.

The note and assignment covered only the oil lease income but this was over 90% of total income. In this regard the statute (Sec. 26 (c) (2)) provides:

“For the purposes of this paragraph, a requirement to pay or set aside an amount equal to a percentage of earnings and profits shall be considered a requirement to pay or set aside such percentage of earnings and profits.”

The fact that the creditor became the actual owner of the earnings by assignment differentiates this case from nearly every decision rendered thus far under Section 26 (c), including those cases decided by the Supreme Court. The *G. B. R. Oil Corporation*, 40 B. T. A. 738, was another case where earnings *were assigned* and the Board in that case upheld the taxpayer. In the *G. B. R.* case the creditor, a bank, did receive the income in the first instance but examination of the case (40 B. T. A. 737 at p. 739) shows that the bank immediately deposited its receipts in the deposit account of the debtor and later

the debtor, after paying expenses, gave the bank a check on the deposit account for an amount to be applied on the debt. In the instant case the creditor permitted the petitioner to collect. The creditor could have required payment to itself direct at any time [Tr. p. 86]. There is no difference in the contracts. The creditor had the same rights under both and actual payment was made under both.

Respectfully submitted,

GEORGE G. WITTER,

Attorney for Appellant.

No. 9824

**In the United States Circuit Court of Appeals
for the Ninth Circuit**

ARTESIAN WATER COMPANY, A CORPORATION, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

ON PETITION FOR REVIEW OF THE DECISION OF THE UNITED
STATES BOARD OF TAX APPEALS

BRIEF FOR THE RESPONDENT

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FILED

AUG 27 1934

WALTER P. CARRIN,

CLERK

INDEX

	Page
Opinion below.....	1
Jurisdiction.....	1
Questions presented.....	2
Statute and regulations involved.....	2
Statement.....	2
Summary of argument.....	4
Argument:	
I. The taxpayer was not entitled to an exemption under Section 14 (d) (2).....	5
II. The taxpayer was not entitled to either of the credits granted in Section 26 (c) (1) or 26 (c) (2).....	10
Conclusion.....	13
Appendix.....	14-18

CITATIONS

Cases:

<i>Bastian Bros. Co. v. McGowan</i> , 113 F. (2d) 489, certiorari denied, 311 U. S. 702.....	11
<i>Brown v. Commissioner</i> , 22 F. (2d) 797.....	6
<i>Central West Public Service Co. v. Craig</i> , 70 F. (2d) 427.....	6
<i>Cincinnati Equipment Co. v. Degnan</i> , 184 Fed. 834.....	8
<i>Coffman v. Publishing Co.</i> , 167 Md. 275.....	9
<i>Commerce Trust Co. v. Woodbury</i> , 77 F. (2d) 478, certiorari denied, 296 U. S. 614.....	6
<i>Cooperative Pub. Co. v. Commissioner</i> , 115 F. (2d) 1017.....	10, 11
<i>Crane-Johnson Co. v. Commissioner</i> , 105 F. (2d) 740, affirmed, 311 U. S. 54.....	10
<i>Dutcher v. Wright</i> , 94 U. S. 553.....	8
<i>Elmhurst Cemetery Co. v. Commissioner</i> , 300 U. S. 37, reversing 83 F. (2d) 4.....	6
<i>Fesler v. Commissioner</i> , 38 F. (2d) 155, certiorari denied, 281 U. S. 755.....	6
<i>Helvering v. Inter-Mountain Insurance Co.</i> , 294 U. S. 686.....	10
<i>Helvering v. Northwest Steel Mills</i> , 311 U. S. 46.....	10, 11, 12, 13
<i>Long v. Republic Varnish Enamel &c., Co.</i> , 115 N. J. Eq. 212.....	9
<i>Oak Woods Cemetery Ass'n v. Commissioner</i> , 111 F. (2d) 863, certiorari denied, 308 U. S. 616.....	6
<i>United States v. Anderson Co.</i> , 119 F. (2d) 343.....	6, 7, 9
<i>Utah Hotel Co. v. Hinckley</i> , 115 F. (2d) 920.....	11

Statute:

Revenue Act of 1936, c. 690, 49 Stat. 1648:	
Section 14.....	14
Section 26.....	14

Miscellaneous:	Page
H. Rep. No. 2475, 74th Cong., 2d Sess., p. 4 (1939-1 Cum. Bull. (Part 2) 667, 669)-----	9
S. Rep. No. 2156, 74th Cong., 2d Sess., p. 14 (1939-1 Cum. Bull. (Part 2) 678)-----	10
Treasury Regulations 94:	
Article 14-1-----	15
Article 26-2-----	16

In the United States Circuit Court of Appeals for the Ninth Circuit

No. 9824

ARTESIAN WATER COMPANY, A CORPORATION, PETITIONER
v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

*ON PETITION FOR REVIEW OF THE DECISION OF THE UNITED
STATES BOARD OF TAX APPEALS*

BRIEF FOR THE RESPONDENT

OPINION BELOW

The opinion of the United States Board of Tax Appeals (R. 21-37) is reported at 43 B. T. A. 408.

JURISDICTION

This case involves deficiencies in income taxes in the calendar year 1937 in the amount of \$7,380.33. (R. 38.) The order of the Board was entered January 24, 1941 (R. 37-38), and the taxpayer filed a petition for review on April 16, 1941 (R. 38-41), in accordance with the provisions of Sections 1141 and 1142 of the Internal Revenue Code.

the notes and made additional payments during 1937, reducing the total balance due to \$100,250. The smaller note was paid off in full during 1937 and the larger one in 1938. (R. 61, 55.)

The taxpayer had net income of \$54,101 during 1937 on which it paid the normal tax. (R. 33, 113.) This case involves the deficiency asserted by the Commissioner of Internal Revenue in the surtax for the year 1937.

The Commissioner, in his deficiency notice, stated that the taxpayer was not, under the facts presented, entitled to an exemption. A credit of \$8,250 representing the amount paid during 1937 on the \$35,000 note was allowed as a credit for contracts restricting dividends.¹ The amounts paid on the \$175,000 note were not allowed. The Board upheld the Commissioner. (R. 22-23.)

SUMMARY OF ARGUMENT

The Board's finding that the taxpayer was not insolvent is supported by substantial evidence and therefore is conclusive on this Court. Hence, it is not entitled to the exemption from the surtax provided in Section 14 (d) (2). The execution of promissory notes, secured by a mortgage on most of taxpayer's assets and by the assignment of a lease constituting the principal source of taxpayer's income, does not constitute a written contract expressly dealing with the payment of dividends nor a written contract expressly dealing with the disposition of earnings and profits, within the meaning of

¹ There is no reference in this record to the contract upon which this credit was based. However, the amount of the credit granted is not in issue.

Section 26 (c) (1) and 26 (c) (2). Hence the corporation is not entitled to a credit under either of those provisions.

ARGUMENT

I

The taxpayer was not entitled to an exemption under section 14 (d) (2)

Section 14 of the Revenue Act of 1936 imposed a surtax on corporate profits, earned but not distributed during the tax year. Section 14 (d) (2) provided an exemption for corporations in bankruptcy or insolvent and in receivership. Section 26 (c) (1) granted a credit for undistributed profits that could not be distributed during the taxable year as dividends "without violating a provision of a written contract executed by the corporation prior to May 1, 1936, which provision expressly deals with the payment of dividends." Similarly, Section 26 (c) (2) granted a credit for undistributed earnings and profits which were required to be paid or irrevocably set aside within the taxable year for the discharge of a debt by "a provision of a written contract executed by the corporation prior to May 1, 1936, which provision expressly deals with the disposition of earnings and profits for the taxable year."

The first question to be resolved is whether this taxpayer was entitled to an exemption under Section 14 (d) (2). We may concede, for the purposes of this part of the argument, that it is enough if the corporation is insolvent and in receivership and the nature of the receivership proceeding is immaterial. However,

the Commissioner and the Board must determine whether the taxpayer was insolvent. Such a determination is essentially a finding of fact which, if supported by substantial evidence, is conclusive. *Elmhurst Cemetery Co. v. Commissioner*, 300 U. S. 37, reversing 83 F. (2d) 4 (C. C. A. 7th); *Oak Woods Cemetery Ass'n. v. Commissioner*, 111 F. (2d) 863 (C. C. A. 7th), certiorari denied, 308 U. S. 616. Of course, if there is no evidence to support the Board's finding, this Court would be entitled to reverse. Cf. *United States v. Anderson Co.*, 119 F. (2d) 343 (C. C. A. 7th); *Commerce Trust Co. v. Woodbury*, 77 F. (2d) 478 (C. C. A. 8th), certiorari denied, 296 U. S. 614; *Central West Public Service Co. v. Craig*, 70 F. (2d) 427 (C. C. A. 8th). However, the taxpayer has the burden of presenting substantial evidence to offset the Commissioner's determination. See *Fesler v. Commissioner*, 38 F. (2d) 155 (C. C. A. 7th), certiorari denied, 281 U. S. 755; *Brown v. Commissioner*, 22 F. (2d) 797 (C. C. A. 5th.)

It cannot seriously be contended that the taxpayer was insolvent in a bankruptcy sense of having liabilities exceeding assets. The balance sheet, as filed with the company's income tax return for the year, showed total assets of \$1,162,798, and total liabilities, exclusive of capital stock and surplus, listed at \$144,255. Substantially, the same situation had existed at the beginning of the year. (R. 33, 113.) In the taxpayer's brief (p. 16) there is an attempt to discredit the Board's finding on the ground that the figures given above were merely book values as of March, 1913, claiming that the values were less in 1937, and that no depletion for

oil had been charged against assets on the books. The only testimony regarding the value of the assets was that the receiver, admittedly not a real estate man, who “wouldn’t know” but “would say” that there would be a substantial difference in such values. (R. 100.) The testimony regarding depletion was to the effect that if the undivided profits at the end of the year of \$34,442 had been reduced by the claimed depletion of \$44,863, there would be no undivided profits balance but a deficit of approximately \$10,400. Admitting the mathematical accuracy of this calculation, it is submitted that it has no effect on the present issue. A deduction from undivided profits would not affect the balance between assets and liabilities, exclusive of capital stock and surplus. Clearly, there is no evidence here which the Board would have been justified in using to offset the balance sheet figures. Nor is there any evidence in the record to warrant a finding that the assets were overvalued on the company’s books by something over a million dollars which would be the adjustment necessary to make liabilities exceed assets.

Therefore, the principal question under the exemption section is whether the taxpayer was insolvent in the so-called equity sense—that is, was it unable to meet its currently maturing obligations. The problem was well posed in *United States v. Anderson Co., supra*, where the court said (p. 345):

The practical question is—Under what circumstances may a court say that a corporation is unable to pay its debts as they fall due in the usual course of trade or business?

It will be noted that in defining insolvency the authorities stress the fact that it means inability to pay debts as they become due in the ordinary course of business. See *Dutcher v. Wright*, 94 U. S. 553; and *Cincinnati Equipment Co. v. Degnan*, 184 Fed. 834 (C. C. A. 6th). The record in this case shows that all debts of this company were paid except the obligation owed to the Pacific Mutual (R. 97), which debt originally fell due in November, 1934. The record is somewhat indefinite with regard to what steps, if any, were taken to secure an extension or to refinance the debt from the due date until 1936. It may be that originally a request for an extension was refused (R. 84) but insofar as there is any substantial evidence in this record it is evident that the negotiations were not seriously undertaken until 1936, although the receiver had been appointed in July, 1935. (R. 77.) At no time did the taxpayer become involved in any legal proceedings because of its inability to pay its bills. (R. 97.) Nothing was paid on the principal of this obligation from the time the loan was made until late in the year 1936. (R. 85.) It was around the middle of 1936 that a conservator had been appointed for the insurance company (R. 46, 78) and it would appear that it was only after that time that the creditor began to be really concerned about the liquidation of the loan (R. 78). There is certainly substantial evidence to support a finding that this obligation was not "currently maturing." Since the debt had originally become due in 1934 and the creditor took no steps for its collection other than to grant an extension in September, 1936, until March, 1937, it is quite

apparent that the creditor was acquiescent in the installment payment of this debt. Moreover, after March, 1937, the creditor continued to permit the debtor to pay off the debt in installments. From these facts it would be impossible to consider that this obligation was one falling due in the ordinary course of business. In effect and in reality, the creditor was placing reliance upon the debtor's ultimate ability to pay and was not demanding immediate payment. This clearly amounts to an extension of credit. When able to meet its obligations by reasonable use of credit a debtor is not insolvent. *United States v. Anderson Co., supra*; *Coffman v. Publishing Co.*, 167 Md. 275, 173 Atl. 248; *Long v. Republic Varnish Enamel &c., Co.*, 115 N. J. Eq. 212, 169 Atl. 860. Since the taxpayer was neither insolvent, in the sense of an excess of liabilities over assets, nor insolvent, in the sense that it could not meet its current obligations, it was not within the terms of the exemption.

As an alternative and additional argument, it is submitted that the taxpayer did not come within the exemption since the receivership intended by this section was obviously intended to mean one caused by financial difficulties and not one arising from disputes between the stockholders, charges of mismanagement, failure to obey the laws, etc. As shown by the Committee Reports on this bill, the intent of Congress was to exempt those corporations in a weak financial condition.² In

² Adequate safeguards are provided in the bill to prevent unreasonable taxation of incomes in the case of corporations in distress or with inadequate earnings to take care of their immediate needs. * * * H. Rep. No. 2475, 74th Cong., 2d Sess.,

the instant case the receivership had no connection with the financial condition of the taxpayer; it arose out of a suit against a stockholder by his judgment creditor and the subsequent officers of the company. (R. 25.) In order for a company to use this exemption, it must be in receivership as well as insolvent. *Cooperative Pub. Co. v. Commissioner*, 115 F. (2d) 1017 (C. C. A. 9th).

II

The taxpayer was not entitled to either of the credits granted in Section 26 (c) (1) or 26 (c) (2)

The theory of the taxpayer's case is that by giving the mortgage note for \$175,000 and assigning the lease to the creditor it became entitled to the credit allowed under Section 26 (c) (1) or (2). It is well settled that a credit provision in the tax law should be as strictly construed as an exempting provision. *Helvering v. Northwest Steel Mills*, 311 U. S. 46; *Helvering v. Inter-Mountain Insurance Co.*, 294 U. S. 686; *Crane-Johnson Co. v. Commissioner*, 105 F. (2d) 740 (C. C. A. 8th), affirmed, 311 U. S. 54. The *Northwest Steel Mills* case is directly contrary to the taxpayer's contention that Section 26 (c) is to be liberally construed. There the Court stated (p. 49):

* * * Congress indicated that any exempted prohibition against dividend payments must be expressly written in the executed contract. * * * the granted credit can only

p. 4 (1939-1 Cum. Bull. (Part 2) 667, 669). To the same effect is S. Rep. No. 2156, 74th Cong., 2d Sess., p. 14 (1939-1 Cum. Bull. (Part 2), 678).

result from a provision which “expressly deals with the payment of dividends.”

There was nothing in the mortgage, nor insofar as the record reveals in the assignment, that “expressly deals with the payment of dividends.” Hence, Section 26 (c) (1) clearly does not apply.

It matters not what was the effect of the state law concerning the mortgage and assignment, since it is well settled that statutes specifically prohibiting dividend payments do not constitute written contract executed by the corporation prohibiting such payments within the meaning of Section 26 (c) (1). *Helvering v. Northwest Steel Mills*, *supra*; *Utah Hotel Co. v. Hinckley*, 115 F. (2d) 920 (C. C. A. 10th); *Bastian Bros. Co. v. McGowan*, 113 F. (2d) 489 (C. C. A. 2d), certiorari denied, 311 U. S. 702; and *Cooperative Pub. Co. v. Commissioner*, *supra*. The whole theory of these authorities is that although the corporation might not be able to declare dividends because of the effect of some superior force upon it, the credit was not allowable except when there was a written contract executed by the corporation dealing expressly and not impliedly with the question.

Similar principles apply in determining whether a credit is allowable under Section 26 (c) (2). In order to be entitled to a credit under that section the corporation must have executed prior to May 1, 1936, a written contract containing a specific provision requiring a portion of its earnings and profits of the taxable year to be paid or set aside in discharge of a debt. There is no such contract here.

Any promise to make periodic payments on an indebtedness would naturally be restrictive as to the earnings and profits of the debtor but it can hardly be contended that Congress meant to include within this section all promises to liquidate just debts. It was intended that the exemption apply only when an explicit contract required it to apply specifically a portion of its earnings for the current year to the payment of a debt. Here the royalties from the lease were paid directly to the taxpayer and the taxpayer concedes that it was properly required to report the royalties as its income. (Br. 20.) Although the creditor might, by virtue of the state law, be entitled to demand them from the taxpayer, it is the force of the state law which gives him this right and not an express contract dealing with the disposition of the earnings and profits. See *Helvering v. Northwest Steel Mills*, *supra*. The income from the lease was assigned as security for the loan. (R. 24.) If the taxpayer chose to pay the creditor from other sources he would not care from what source he were paid. Clearly this assignment as security was not an express contract requiring the debtor to pay or irrevocably set aside a portion of the earnings during the taxable year.

If the taxpayer's theory were applied literally, it would follow that all payments on account of legally owing debts would constitute a credit against this tax, since any payment on a debt will have a restrictive effect on the company's profits. It is a rare corporation that is not making payments on borrowed capital. But Congress has not provided relief in such cases. It

has stated with meticulous care the circumstances under which a credit would be allowed. The allowance of credits and deductions is within the discretion of Congress and the language of the statute cannot be stretched to cover this case because of any alleged hardship on the taxpayer. See *Helvering v. Northwest Steel Mills*, *supra*.

Moreover, the hardship here is more imaginary than real. This corporation was a profitable going concern during the year in question and should not escape this tax merely because during those years it repaid a large amount of its indebtedness. If there could be any unfairness in the instant case, it would be the unfairness to other corporations which paid this tax while making a profit although not in a sound enough financial condition to repay their capital investments.

CONCLUSION

The decision of the Board that the taxpayer was not exempt and was not entitled to a credit for the amounts paid was correct and should be affirmed.

Respectfully submitted.

SAMUEL O. CLARK, Jr.,
Assistant Attorney General.

HELEN R. CARLOSS,
SHERLEY EWING,

Special Assistants to the Attorney General.

AUGUST, 1941.

APPENDIX

Revenue Act of 1936, c. 690, 49 Stat. 1648:

SEC. 14. SURTAX ON UNDISTRIBUTED PROFITS.

* * * * *

(b) *Imposition of Tax.*—There shall be levied, collected, and paid for each taxable year upon the net income of every corporation a surtax equal to the sum of the following, subject to the application of the specific credit as provided in subsection (c):

7 per centum of the portion of the undistributed net income which is not in excess of 10 per centum of the adjusted net income.

* * * * *

(d) *Exemption From Surtax.*—The following corporations shall not be subject to the surtax imposed by this section:

* * * * *

(2) Domestic corporations which for any portion of the taxable year are in bankruptcy under the laws of the United States, or are insolvent and in receivership in any court of the United States or of any State, Territory, or the District of Columbia.

* * * * *

SEC. 26. CREDITS OF CORPORATIONS.

In the case of a corporation the following credits shall be allowed to the extent provided in the various sections imposing tax—

* * * * *

(c) *Contracts Restricting Payment of Dividends.*—

(1) PROHIBITION ON PAYMENT OF DIVIDENDS.—An amount equal to the excess of the adjusted net income over the aggregate of the amounts

which can be distributed within the taxable year as dividends without violating a provision of a written contract executed by the corporation prior to May 1, 1936, which provision expressly deals with the payment of dividends. If a corporation would be entitled to a credit under this paragraph because of a contract provision and also to one or more credits because of other contract provisions, only the largest of such credits shall be allowed, and for such purpose if two or more credits are equal in amount only one shall be taken into account.

(2) DISPOSITION OF PROFITS OF TAXABLE YEAR.—An amount equal to the portion of the earnings and profits of the taxable year which is required (by a provision of a written contract executed by the corporation prior to May 1, 1936, which provision expressly deals with the disposition of earnings and profits of the taxable year) to be paid within the taxable year in discharge of a debt, or to be irrevocably set aside within the taxable year for the discharge of a debt; to the extent that such amount has been so paid or set aside. For the purposes of this paragraph, a requirement to pay or set aside an amount equal to a percentage of earnings and profits shall be considered a requirement to pay or set aside such percentage of earnings and profits. As used in this paragraph, the word “debt” does not include a debt incurred after April 30, 1936.

* * * * *

Treasury Regulations 94, promulgated under the Revenue Act of 1936:

ART. 14-1. *Surtax on undistributed profits of corporations.*—

* * * * *

A domestic corporation is not subject to the surtax on undistributed profits if for any portion of its taxable year—

(1) it is in bankruptcy under the laws of the United States; or

(2) it is insolvent and in receivership in any court of the United States or any State, Territory, or the District of Columbia.

* * * *

ART. 26-2. *Credit in connection with contracts restricting payment of dividends.*—(a) The credit provided in section 26 (c) with respect to contracts restricting the payment of dividends is not available under every contract which might operate to restrict the payment of dividends, but only with respect to those provisions of written contracts executed by the corporation prior to May 1, 1936, which satisfy the conditions prescribed in the Act. The charter of a corporation does not constitute a written contract executed by the corporation within the meaning of section 26 (c). The provisions recognized by the Act are of two general types, as follows:

(1) Those which come within section 26 (c) (1), in that they prohibit or limit the payment of dividends during the taxable year; and

(2) Those which come within section 26 (c) (2), in that they require the payment, or irrevocable setting aside, within the taxable year, of a specified portion of the earnings or profits of the taxable year for the discharge of a debt incurred on or before April 30, 1936.

* * * *

(b) *Prohibition on payment of dividends.*—The credit provided in section 26 (c) (1) is allowable only with respect to a written contract executed by the corporation prior to May 1, 1936, which expressly deals with the payment of dividends and operates as a legal restriction upon the corporation as to the amounts which it can distribute within the taxable year as dividends. If an amount can be distributed within the taxable year as a dividend—

(1) in one form (as, for example, in stock or bonds of the corporation) without violating the

provisions of a contract, but can not be distributed within the taxable year as a dividend in another form (as, for example, in cash) without violating such provisions, or

(2) at one time (as, for example, during the last half of the taxable year) without violating the provisions of a contract, but can not be distributed as a dividend at another time within the taxable year (as, for example, during the first half of the taxable year) without violating such provision—

then the amount is one which, under section 26 (c) (1), can be distributed within the taxable year as a dividend without violating such provisions.

The credit provided in section 26 (c) (1) is equal to the excess of the adjusted net income, as defined in section 14 (a), over the aggregate of the amounts which can be distributed within the taxable year without violating the provisions of such contract. The requirement that the provisions of the contract expressly deal with the payment of dividends is not met in case (1) a corporation is merely required to set aside periodically a sum to retire its bonds, or (2) the contract merely provides that while its bonds are outstanding the current assets shall not be reduced below a specified amount.

* * * * *

(c) *Disposition of profits of taxable year.*—Under the provisions of section 26 (c) (2), a corporation is allowed a credit in an amount equal to that portion of the earnings and profits of the taxable year which, by the terms of a written contract executed by the corporation prior to May 1, 1936, and expressly dealing with the disposition of the earnings and profits of the taxable year, it is required within the taxable year to pay in, or irrevocably to set aside for, the discharge of a debt incurred on or before April 30, 1936. The credit is limited to that amount

which is actually so paid or irrevocably set aside during the taxable year pursuant to the requirements of such a contract.

Only a contractual provision which expressly deals with the disposition of the earnings and profits of the taxable year shall be recognized as a basis for the credit provided in section 26 (c) (2). A corporation having outstanding bonds is not entitled to a credit under a provision merely requiring it, for example, (1) to retire annually a certain percentage or amount of such bonds, (2) to maintain a sinking fund sufficient to retire all or a certain percentage of such bonds by maturity, (3) to pay into a sinking fund for the retirement of such bonds a specified amount per thousand feet of timber cut or per ton of coal mined, or (4) to pay into a sinking fund for the retirement of such bonds an amount equal to a certain percentage of gross sales or gross income. Such provisions do not expressly deal with the disposition of earnings and profits of the taxable year. A contractual provision, however, shall not be considered as not expressly dealing with the disposition of earnings and profits of the taxable year merely because it deals with such earnings and profits in terms of "net income," "net earnings," or "net profits."

United States
7
Circuit Court of Appeals

For the Ninth Circuit.

BANK OF AMERICA NATIONAL TRUST
AND SAVINGS ASSOCIATION, Trustee of
the John and Pauline Tonningsen Trust,
Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

Transcript of the Record

Upon Petition to Review a Decision of the United States
Board of Tax Appeals.

FILED

JUN 25 1941

PAUL F. O'BRIEN,
CLERK

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INDEX

[Clerk's Note: When deemed likely to be of an important nature, errors or doubtful matters appearing in the original certified record are printed literally in *italic*; and, likewise, cancelled matter appearing in the original certified record is printed and cancelled herein accordingly. When possible, an omission from the text is indicated by printing in *italic* the two words between which the omission seems to occur.]

	Page
Agreed Statement of the Proceedings on Review	1
Certificate of Board Member	14
Statement of Facts Averred and Proved and Which are Essential to a Decision of the Questions by the Circuit Court of Appeals	5
Statement of How Questions Arose and were Decided in the Board of Tax Ap- peals	4
Statement of Questions Involved	2
Venue and Jurisdiction	2
Exhibits to Agreed Statement:	
A—Petition for Review	15
B—Statement of Points, etc. (Board of Tax Appeals)	18
C—Findings of Fact and Opinion	25
Opinion	35
D—Decision	44
E—Letter dated December 26, 1934	45
F—Agreement dated April 3, 1935	47

	Page
G—Schedule of principal account 1935	51
H—Schedule of principal and income accounts 1936	53
I—Agreement dated June 12, 1936	57
J—Agreement dated June 12, 1936	60
Certificate of Clerk of Board of Tax Appeals.....	62
Designation of Contents of Record on Review...	63
Statement of Points on Review (Board of Tax Appeals)	18
Statement of Points on Review (Circuit Court of Appeals)	63

United States Circuit Court of Appeals
For the Ninth Circuit

No. 99280

JOHN AND PAULINE TONNINGSEN TRUST,
BANK OF AMERICA NATIONAL TRUST
AND SAVINGS ASSOCIATION, Trustee,
Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

AGREED STATEMENT OF THE PROCEED-
INGS ON REVIEW

Come now the parties to the above entitled cause, and by their counsel of record agree that, pursuant to the rules of this court in such case made and provided (Rule 76 of the Federal Rules of Civil Procedure as incorporated into Rule 30 of this court), the following statement shows how the questions regarding which review is sought arose and were decided before the United States Board of Tax Appeals, sets forth as many of the facts averred and proved or sought to be proved as are essential to a decision of said questions by this court, and is in all respects sufficient to enable this court to review the cause and [1*] determine the issues presented herein by the petitioner on review.

*Page numbering appearing at foot of page of original certified Transcript of Record.

thereto to avoid the penalty prescribed by section 291 of said Act.

Statement of How Questions Arose and Were
Decided in the Board of Tax Appeals

One notice of deficiency covering all of the foregoing matters was mailed to petitioner by respondent on March 22, 1939. Within ninety days after the mailing [4] of said notice petitioner filed its petition with the Board of Tax Appeals for a redetermination of said deficiencies, including said penalty. Respondent filed his answer, and the case was duly set for hearing, and was heard on oral testimony and certain exhibits, at San Francisco, California, on May 22, 1940, the Honorable Clarence V. Opper presiding.

After hearing, and on December 10, 1940, said Board promulgated and entered its Findings of Fact and opinion, a copy of which is annexed hereto as "Exhibit C" and hereby made a part hereof. Thereafter, and on January 31, 1941, pursuant to said Findings of Fact and Opinion, said Board rendered and entered its Decision, a copy of which is annexed hereto as "Exhibit D" and hereby made a part hereof. In and by said Decision said Board determined that there were deficiencies in petitioner's income tax for the years 1935 and 1936, as determined by respondent, and that there was no penalty due from petitioner for the year 1936.

Statement of Facts Averred and Proved and which are Essential to a Decision of the Questions by the Circuit Court of Appeals

Petitioner, a national banking association [5] with principal offices at San Francisco, California, is and at all times herein mentioned was the duly qualified and acting trustee of the John and Pauline Tonningsen trust (hereinafter referred to as the "trust"), created under date of August 7, 1930. The trust names John Tonningsen as the first trustor and Pauline E. Tonningsen, his wife as the second trustor, and petitioner's predecessor as the trustee.

Those parts of the trust agreement and the amendments thereto which are pertinent to the issues before the Board of Tax Appeals and to the questions presented by petitioner's Petition for Review are those specifically set forth in the Findings of Fact and Opinion of the Board of Tax Appeals, a copy of which is annexed hereto and marked "Exhibit C".

John Tonningsen died November 28, 1933. Thereafter, and until her death (January 25, 1936), the net ordinary income of the trust was paid to Pauline E. Tonningsen.

As the time of the death of John Tonningsen, respondent valued the assets of the trust at \$702,222.51. The trust estate was composed of real and personal property and yielded net income as follows: [6]

1931	\$70,970.00
1932	73,984.18
1933	47,693.67
1934	45,571.58
1935 (11 months)	45,938.85

The petitioner's account for the year 1935 reveals that, from ordinary income of the trust, taxable and exempt, realized during that year, \$46,858.47 was paid to Pauline E. Tonningsen and \$2,417.99 was on hand at the end of the year, payable to her.

From the time of the death of John Tonningsen until her death, Pauline E. Tonningsen resided at the Hotel St. Francis, San Francisco, California, with her niece, Louise Weyer. They occupied a suite of four rooms, for which Mrs. Tonningsen paid the rent.

Prior to her husband's death, Mrs. Tonningsen had been paralyzed, and from the date of his death until her own death, at the age of eighty-three years, seven months and three days, she was confined to her bed and wheel chair. She was unable to walk and never left her suite. She was under constant care of physicians and had a day nurse and a night nurse continually in attendance. She had no servants other than the hotel afforded, and did not entertain, except to receive her close friends. [7]

The hotel books showed expenses incurred by her of \$1,338.98 for November and December, 1933; \$8,210.22 for 1934; \$8,744.05 for 1935; and \$723.91 for January, 1936. The above sums were for rent and meals for herself and Louise Weyer. Her bills for physicians' services totaled \$635.00, \$796.00 and \$122.00 for the years 1934, 1935 and 1936, respectively.

Pauline E. Tonningsen had no children. She had

other relatives by blood and marriage, but did not remember them in her will.

At the time of her death, January 25, 1936, Pauline E. Tonningsen had an individual separate estate subsequently appraised at \$87,046.67, and bank accounts in joint tenancy with Louise Weyer, in the sum of \$103,067.06. Louise Weyer was the recipient of the decedent's estate, bank accounts in joint tenancy and gifts in contemplation of death, in the total sum of \$161,745.92.

All payments made to Pauline E. Tonningsen were deposited in her commercial account at the Bank of America. The balance in this account was \$36,615.78 on January 2, 1935, and \$36,088.00 on December 31, 1935. [8] Over objection that the evidence was immaterial and irrelevant, petitioner was permitted to show that Pauline E. Tonningsen opened a savings account with the same institution on January 5, 1934, with a deposit of \$228.15; that by virtue of deposits aggregating \$19,047.26 and interest credits of \$334.32, the balance in said account on December 31, 1934, was \$19,609.73; that during the year 1935, there was deposited in this account the sum of \$5,390.27 in amounts and on dates which corresponded with withdrawals from the aforementioned commercial account; that no withdrawals were made from this savings account during the life of Pauline E. Tonningsen, and that the balance therein, on December 31, 1935, including interest credits of \$523.97 in 1935, which was unchanged at

the time of the death of Pauline E. Tonningsen, was \$25,523.97.

After the death of John Tonningsen, Pauline E. Tonningsen made demand upon petitioner, through her attorney, for the payment of \$5,000.00 a month. Pauline E. Tonningsen was informed that petitioner would not invade the corpus, but that the requested payments would be made if the consent of the charitable remaindermen were secured. During the year 1934, petitioner paid [9] Pauline E. Tonningsen \$16,614.53 from the corpus of the trust, with the consent of the charities. Over objection that the evidence was immaterial, incompetent and hearsay, petitioner was permitted to show that on December 26, 1934, the attorney for Pauline E. Tonningsen addressed to each of the charitable remaindermen a letter in form and substance the same as "Exhibit E" annexed hereto and made a part hereof. Subsequently, on April 3, 1935, the charitable remaindermen executed the agreement annexed hereto and marked "Exhibit F".

During the calendar year 1935, in addition to ordinary income, which was paid out and distributed by petitioner, the trust realized the sum of \$32,-785.40 as recognizable capital gains. By reason of the foregoing agreement, \$9,545.80 was paid to Pauline E. Tonningsen out of the principal of the trust during that year. The capital gains realized, and the disbursements made by petitioner from principal during the calendar year 1935 are set

forth in "Exhibit G" annexed hereto and hereby made a part hereof.

Petitioner filed a return for 1935, on a cash basis, with the Collector of Internal Revenue at San Francisco, California. [10]

* * * * *

Petitioner filed with the Collector of Internal Revenue at San Francisco a return for the year 1936, on a cash basis, on Form 1041. The amounts received and disbursed by petitioner during the year 1936, as revealed by (1) petitioner's accounts, (2) the return filed by petitioner, and (3) by respondent's determination, are set forth in "Exhibit H" annexed hereto and hereby made a part hereof.

During 1936 the petitioner realized gross taxable income of \$74,989.57. Respondent concedes deductions of \$3,146.74, miscellaneous expenses, and \$43,450.17, capital gains permanently set aside for charitable organizations.

Petitioner's account shows: That the balance on hand in the income account at the beginning of the calendar year 1936 was \$2,417.99; that prior to the death of Pauline E. Tonningsen on January 25, 1936, petitioner received income in the amount of \$7,953.01; that from the foregoing there was paid \$5,000.00 to Pauline E. Tonningsen and \$448.78 on account of the fees of the petitioner, leaving a balance on hand at the time of her death of \$4,922.22. Petitioner transferred this balance to the principal account on the [11] date of the death of Pauline E. Tonningsen.

Petitioner paid \$600.00 monthly, commencing with February 26, 1936, on or about the 25th day of each month thereafter, to the individual beneficiaries mentioned in Article VII(c) of the trust agreement. These sums were charged by petitioner to the income account, as provided therein.

On May 16, 1936, petitioner paid the sum of \$200.00 for the care and upkeep of the cemetery vault mentioned in Article VII(a) of the trust agreement. This sum was charged to the income account. On July 26, 1936, the Superior Court of the State of California, in and for the City and County of San Francisco, decreed that the clause of the trust providing for the care and upkeep of the cemetery vault was invalid, and authorized the trustee to hold the trust free of any obligation to keep and repair the vault.

The executors of the estate of John Tonningsen filed a Federal Estate Tax return which did not include the tax payable by virtue of the assets in the trust. Petitioner reported these assets and subsequently, on November 19, 1935, a deficiency in estate tax in the amount of \$90,878.00 was proposed against the executors [12] of the estate of John Tonningesen. The executors thereupon sought to have the petitioner pay all or a part of the deficiency out of the trust property. The executors contended that the trust was liable for all or a part of the Federal Estate Tax due from the estate, which was predicated on the inclusion of the corpus of the trust in the gross estate because of the provision for the

payment of estate tax appearing in Article VII(a) of the trust agreement. The trustees denied liability on the ground that the payments specified in Article VII(a) were to be made upon the death of the survivor of the trustors. Pauline E. Tonningsen still being alive, no payments could be made. A similar question arose in connection with the California Inheritance Tax. The trustees realized they might be liable, so they employed counsel and sought to be recognized by the Commissioner as a taxpayer. Over the objection of petitioner, respondent was permitted to introduce in evidence a letter from petitioner's attorney, in which he stated, in appealing to the Commissioner to permit the petitioner to be represented at the proceedings, that petitioner was willing to pay a share of the tax. Petitioner caused evidence to be presented to the Commissioner, and under date of March 2, 1936, the deficiency was reduced to [13] \$26,037.88. The reduction in the deficiency was predicated upon the allowance by the Commissioner of \$472,672.74 as the value of the remainder interest in the corpus of the trust which was allowed as a charitable gift. On April 13, 1936, by reason of minor adjustments, the deficiency was reduced to \$25,645.74, and prior to June 9, 1936, after allowance for State Inheritance Tax credit, the deficiency was finally assessed in the sum of \$23,424.36.

On June 12, 1936, the executors of the estate of John Tonningsen and petitioner compromised their

dispute as to the payment of the Federal Estate Tax and State Inheritance taxes. A copy of his agreement is annexed hereto and marked "Exhibit I", and hereby made a part hereof. On the part of the petitioner, said agreement was made conditional upon the consent of the charitable remaindermen. Consents and waivers in the form set forth in "Exhibit J", annexed hereto and hereby made a part hereof, were secured from the charities.

On June 30, 1936, the petitioner paid the executors of the estate of John Tonningsen, pursuant to the foregoing agreement, on account of Federal [14] Estate taxes, \$15,616.24, being two-thirds of the deficiency, and \$1,436.70, being two-thirds of the interest thereon, and \$1,480.92, being two-thirds of the California Inheritance Tax. These sums were charged to the principal account of the trust by petitioner. The balance on hand in the income account of the trust on June 30, 1936, after the allowance of such of the payments heretofore mentioned as preceded that date, and the ordinary expenses of the trust, was \$11,235.83. The executors paid the deficiency and the interest in June, 1936.

On November 16, 1935, petitioner had paid the attorney representing it in connection with the Federal Estate Tax proposed deficiency, \$500.00, and had charged the same to the principal account of the trust. On July 9, 1936, \$500.00 was credited to the principal account and charged against the income account of the trust, and an additional

\$1,000.00 was paid to the attorney. Subsequently, on July 22, 1936, an additional \$6,000.00 was paid to the attorney and charged to the income account. The sum of \$7,500.00 was claimed as a deduction from gross income on the return filed for the year 1936. [15]

At the end of July, and the end of December, 1936, respectively, petitioner paid the balance of the net income on hand to the charities designated in the trust instrument. These payments aggregated \$17,178.44, and were charged against the income account of the trust.

During the period from February 8, 1936, to April 2, 1936, petitioner made payments totaling \$100,000.00 under Article VII(b) of the trust agreement to the parties named therein. These payments were charged to the principal account of the trust as augmented by the balance of income on hand transferred to principal on the death of Pauline E. Tonningsen.

In determining the deficiency for 1936, respondent reduced the amounts distributed by petitioner by the sum of \$18,533.86, which had been charged to principal on June 30, 1936, and disallowed the deduction of the \$7,500.00 paid for attorney's fees. Taxable and tax exempt income were apportioned to the payment of these amounts, and the aggregate of the taxable income thereby applied, in the sum

of \$18,958.23, was made the basis of the proposed deficiency for the year [16] 1936.

Dated, May, 1941.

J. W. RADIL

F. J. KILMARTIN

Attorneys for Petitioner

J. P. WENCHEL

Chief Counsel, Bureau of
Internal Revenue

ALVA C. BAIRD

T. M. MATHER

HARRY R. HORROW

Attorneys for Respondent [17]

The undersigned Member of the United States Board of Tax Appeals hereby approves the foregoing Agreed Statement of the Proceedings on Review, pursuant to Rule 76 of the Federal Rules of Civil Procedure.

Dated, May 28, 1941.

(Sgd) CLARENCE V. OPPER

Member, United States Board
of Tax Appeals

[Endorsed]: U. S. B. T. A. Filed May 26, 1941.

[18]

EXHIBIT A

United States Board of Tax Appeals

Docket No. 99280

JOHN AND PAULINE TONNINGSEN TRUST,
BANK OF AMERICA NATIONAL TRUST
AND SAVINGS ASSOCIATION, Trustee,
Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

PETITION FOR REVIEW

Bank of America National Trust and Savings Association, Trustee of the John and Pauline Tonningesen Trust, hereby petitions for a review in the United States Circuit Court of Appeals for the Ninth Circuit from so much of the decision of the Board of Tax Appeals which was entered in the above entitled matter on January 31, 1941, pursuant to findings of fact and opinion promulgated December 10, 1940 (43 B. T. A. 37 [No. 8]), as determined that petitioner was liable for deficiencies in income taxes for the calendar years 1935 and 1936.

Nature of the Controversy

This controversy involves asserted deficiencies in the petitioner's income taxes for the taxable years 1935 and [19] 1936 in the amounts of \$4,610.65 and

\$1,713.74, respectively, and an alleged penalty of \$428.44 for the calendar year 1936.

The question in reference to the year 1935 is whether petitioner is entitled to a deduction under the provisions of section 162(a) of the Revenue Act of 1934, of capital gains realized by it during that year as gross income, which, pursuant to the terms of the deed creating the trust, was, during the taxable year, permanently set aside for or to be used for charitable purposes in accordance with the provisions of said Act.

The questions in reference to the year 1936 are, first, whether, by reason of the provisions of the trust, there should be included in petitioner's taxable income sums paid by it to the legal representative of the estate of the first trustor in satisfaction of a controversy regarding the liability of the trust for Federal Estate taxes and State Inheritance taxes arising on the death of said trustor, which said sums petitioner purported to pay out of the principal of the trust, and whether there should be an attendant denial of a deduction under section 162(a) of the Revenue Act of 1936, of amounts which petitioner purported to pay out of income to charitable beneficiaries of the trust; and, second, whether, by reason of the provisions of the trust, there should be included in petitioner's taxable income sums paid [20] by it for legal expenses attendant to securing a reduction in Federal Estate Taxes, which said sums petitioner purported to pay out of the income of the trust, and, if so, whether said

sums are an allowable deduction under sections 162 and 23(a)(1) of the Revenue Act of 1936.

The question with reference to the penalty was determined in favor of petitioner and against respondent, and no review is sought of said determination.

The Court in Which Review Is Sought

Petitioner seeks review in the United States Circuit Court of Appeals for the Ninth Circuit.

Allegations to Establish Venue

Petitioner is and was during the taxable years in controversy a national banking association duly incorporated under the laws so provided, with its principal offices at San Francisco, California. The Collector's Office to which was made the returns of taxes, in respect of which the liability is alleged to arise, is located at San Francisco, California, in the Ninth Judicial Circuit.

Wherefore, petitioner prays that the proceedings of the Board of Tax Appeals in the above entitled matter, [21] in so far as it was therein determined that petitioner was liable for deficiencies in income taxes for the years 1935 and 1936, be reviewed by the United States Circuit Court of Appeals for the Ninth Circuit; that the Clerk of the Board of Tax Appeals prepare and transmit to said United States Circuit Court of Appeals for the Ninth Circuit a record of the proceedings before said Board of Tax Appeals in the manner and form provided by the

statutes of the United States, the Rules of said Board of Tax Appeals, the Rules of said Circuit Court, and the Federal Rules of Civil Procedure; and petitioner further prays that upon said review the aforementioned findings of fact and conclusions of law and decision of the Board of Tax Appeals, in so far as they determine said deficiencies, be reversed and said petitioner relieved of the deficiencies imposed thereby.

J. W. RADIL,

F. J. KILMARTIN,

Attorneys for Petitioner.

[Endorsed]: U. S. B. T. A. Filed April 26,
1941. [22]

EXHIBIT B

[Title of Board and Cause.]

STATEMENT OF POINTS TO BE RELIED UPON ON APPEAL

For the Alleged Deficiency for 1935

I.

The Board of Tax Appeals erred in its decision that there is a deficiency in petitioner's income tax for the year 1935.

II.

The Board of Tax Appeals erred, in that the following findings of fact, express or implied, are not supported by the evidence:

A.

That the capital gains which were added to corpus in 1935 cannot be said to have been paid or permanently set aside for charitable purposes pursuant to the terms of the instrument creating the trust. [23]

B.

(1) That there was a reasonable likelihood that the capital gains for 1935 were not protected from invasion in favor of the individual beneficiaries pursuant to the terms of the instrument creating the trust; and

(2) That the corpus, of which these capital gains became an indistinguishable part, was not so protected from invasion, pursuant to the terms of the instrument creating the trust and the circumstances of the beneficiary and trust estate, as to demonstrate that said capital gains were, pursuant to the terms of the instrument creating the trust, permanently set aside for the benefit of charities.

C.

(1) That Pauline Tonningsen was in 1935, or would be during her lifetime, in need of a greater amount than the ordinary net income of the trust for her care, maintenance and support, or by reason of illness or other emergency;

(1b) That Pauline Tonningsen had more than one nurse continuously in attendance from the date of the death of John Tonningsen until her own death; and

(2) That petitioner deemed such amounts as were actually paid to Pauline Tonningsen from the corpus of the trust during 1934 and 1935 or, in the exercise of its absolute discretion would have occasion in the future to deem further amounts from the corpus of the trust, necessary [24] and appropriate for the care, maintenance and support of Pauline Tonningsen or by reason of her illness or other emergency.

D.

(1) That Pauline Tonningsen was within her rights in demanding payments, pursuant to the terms of the instrument creating the trust, from the corpus thereof;

(2) That the consent of the charitable remaindermen to such invasions proceeded from a recognition on their part that a litigated contest over her right, under the terms of the instrument creating the trust, would result unfavorably to them; and

(3) That the consent of the charitable remaindermen would be forthcoming for ensuing years during the life of Pauline Tonningsen.

III.

The Board of Tax Appeals erred in that it failed to find as follows in conformance with the evidence:

A.

That the capital gains realized by petitioner in 1935 were permanently set aside and used for char-

itable purposes pursuant to the terms of the instrument creating the trust.

B.

That there was no likelihood or reasonable probability [25] that the corpus of the trust estate was or would be subject to invasion, pursuant to the terms of the instrument creating the trust, for the care, maintenance or support of Pauline Tonning-sen, or by reason of her illness or other emergency.

C.

That the amounts paid out of corpus to Pauline Tonningsen in 1934 and 1935 were not paid or payable to her pursuant to the terms of the instrument creating the trust but were, in fact, paid out of the equitable interest of the charitable remaindermen of the trust by agreement with them.

IV.

That the Board of Tax Appeals erred in that the following conclusions of law are contrary to law:

A.

That the capital gains which were added to corpus in 1935 cannot be said to have been paid or permanently set aside for charitable purposes pursuant to the terms of the instrument creating the trust.

B.

(1) The conclusions set forth under parts (1) and

(2) of section B of paragraph II, above, in so far as they embody conclusions of law; and

(2) That the question (of the reasonable likelihood of the invasion of corpus) is a “‘factual one’”, [26] controlled not by the legal rights of the parties but by the actual probabilities.

C.

The conclusions set forth under part (2) of section C of paragraph II, above, in so far as it embodies conclusions of law.

D.

The conclusions set forth under parts (1) and (2) of section D of paragraph II, above, in so far as they embody conclusions of law.

For the Alleged Deficiency for 1936

I.

The Board of Tax Appeals erred in its decision that there is a deficiency in petitioner's income tax for the year 1936.

II.

The Board of Tax Appeals erred in that the following findings of fact, express or implied, are not supported by the evidence:

A.

(1) That pursuant to the terms of the instrument creating the trust the state inheritance tax or federal estate tax due by virtue of the death of the trustor first to die, as distinguished from that

ensuing on the death of the survivor, was to be paid from the trust. [27]

(2) That pursuant to the terms of the instrument creating the trust, any state inheritance tax or federal estate tax properly chargeable against the trust was to be paid from income received after the death of the survivor.

(3) That there was any state inheritance tax or federal estate tax due from the trust, or any share or interest therein; and

(4) That the trust deed required that the estate taxes and attorneys' fees be paid out of income of the trust received in the year of the death of the survivor, if sufficient therefor.

B.

(1) That the trust was not engaged in a trade or business; and

(2) That the attorneys' fees were not deductible as an ordinary and necessary business expense.

C.

That the trustee was precluded from distributing, pursuant to the terms of the instrument creating the trust, income equal to the amounts paid out for estate taxes and attorneys' fees, to the charitable beneficiaries.

III.

The Board of Tax Appeals erred in that it failed to find as follows in conformance with the evidence:

[28]

A.

(1) That pursuant to the terms of the instrument creating the trust, the only state inheritance tax or federal estate tax to be paid by the trust was that due by virtue of the death of the survivor.

(2) That pursuant to the terms of the instrument creating the tax, any state inheritance tax or federal estate tax properly chargeable against the trust was to be paid from income only in so far as income was sufficient at the date of the death of the survivor.

(3) That the sum of \$18,533.86 was paid to the executors of John Tonningsen, not as a tax, but by way of compromise of an alleged liability.

(4) That under the terms of the instrument creating the trust petitioner properly paid the sum of \$18,533.86 from the corpus of the trust; and

(5) That the attorneys' fees as an extraordinary expense of the trust were properly payable out of the corpus of the trust pursuant to the terms thereof.

B.

That the attorneys' fees, if properly payable out of the income of the trust, were a deductible expense.

C.

That petitioner was entitled to deductions of \$11,600.00 for distribution to individual beneficiaries, and [29] \$17,178.45 for distribution to the charitable beneficiaries in the year 1936.

IV.

That the Board of Tax Appeals erred in that the following conclusions of law are contrary to law:

A.

The conclusions set forth under parts (1), (2), (3) and (4) of section A of paragraph II, above, in so far as they embody conclusions of law.

B.

The conclusions set forth under parts (1) and (2) of section B of paragraph II, above, in so far as they embody conclusions of law.

C.

The conclusions set forth in section C of paragraph II, above, in so far as it embodies conclusions of law.

J. W. RADIL,

F. J. KILMARTIN,

Attorneys for Petitioner.

[Endorsed]: U. S. B. T. A. Filed April 26, 1941.

[30]

EXHIBIT C

[Title of Board and Cause.]

Docket No. 99280. Promulgated December 10, 1940.

FINDINGS OF FACT AND OPINION

1. Where corpus of trust was in fact invaded and payments therefrom made to life bene-

ficiary, capital gains allocable to corpus under California law were not "permanently set aside" for charitable remaindermen so as to justify the deduction provided by section 162 (a), Revenue Act of 1934.

2. Where trust instrument provided for the payment of estate taxes and attorneys' fees out of the income of the trust, income thus used held not paid to charities within section 162 (a), Revenue Act of 1936.

3. Where trust filed information return 1041, adequacy of information given therein not being challenged, and regulations not clearly providing for filing of additional return, held imposition of penalty under section 291 of the Revenue Act of 1936 for failure to file return "required by this title" unauthorized.

F. J. Kilmartin, Esq., and J. W. Radil, Esq., for the petitioner.

Harry R. Horrow, Esq., for the respondent.

This proceeding was brought for a redetermination of deficiencies in income tax for the years 1935 and 1936 in the amounts of \$4,610.65 and \$1,713.74, respectively. A penalty of \$428.44 is asserted for the year 1936.

The sole question involved with respect to the year 1935 is whether petitioner is entitled to a deduction under the provisions of section 162 (a) of the Revenue Act of 1934 of capital gains realized by it during the year but covered into corpus as an

accretion thereto and not distributed as net income to the life beneficiaries.

With respect to the year 1936 the questions are whether by reason of provisions of the trust there should be included in petitioner's taxable income sums paid by it for legal expenses and Federal estate taxes or whether these items give rise to a deduction under the provisions of section 162 (a) of the Revenue Act of 1936, and whether the asserted penalty for failure to file should be sustained. [31]

FINDINGS OF FACT.

Petitioner, a national banking association with principal offices at San Francisco, California, is and at all times herein material was the duly qualified and acting trustee of the John and Pauline Tonningsen trust (hereinafter referred to as the trust), created under date of August 7, 1930. The trust names John Tonningsen as the first trustor and Pauline E. Tonningsen, his wife, as the second trustor and petitioner's predecessor, the trustee.

Those parts of the trust agreement and the amendments thereto which are pertinent to the issues before us are as follows:

Article IV.

The Trustee shall take, collect and receive the income of the trust fund and estate, and after paying therefrom the costs and expenses of the trust, shall pay said net income to the First Trustor during his lifetime * * *.

In the event that the Second Trustor should survive the Trustor, and this Trust becomes irrevocable under the provisions hereinafter contained, the Trustee shall pay to said Second Trustor, all of the net income of the trust fund and estate, in convenient installments, as nearly equal in amount as the condition of the Trust will permit, and should the said Second Trustor be in need of a greater amount than said net income for her care, maintenance and support, or by reason of illness or other emergency, the Trustee may, in its absolute discretion, pay to her, out of the principal of the trust fund and estate, such additional amounts as it may deem necessary and appropriate for the purposes aforesaid, and no one, howsoever interested in the Trust, shall be competent to object thereto.

* * * * *

Article VII.

If not revoked by the First Trustor, during his lifetime, the Trust shall become irrevocable upon the death of the First Trustor, and should the Second Trustor survive him, the Trust shall be administered for her use and benefit as hereinbefore provided, and upon the death of the survivor of the Trustors, the Trustee shall administer the trust thereof in the manner following, to-wit:

(a) Out of the income of the trust fund and estate, if that be sufficient, or out of the princi-

pal thereof, if necessary, the Trustee shall pay the costs and expenses of the surviving Trustor's last illness and of his or her funeral and burial, unless other provision shall have been made therefor, and the inheritance tax upon all distributive shares of or interests in the trust fund and estate, if any be due, and any Federal Estate Tax due upon the whole thereof, and the costs and expenses of the Trust, including the compensation of the Trustee and all preferred claims or charges against the trust estate, including interest thereon, and the Trustee, during the continuance of this Trust, shall, in its absolute discretion, devote such sums as it may deem necessary for the care and upkeep of the Pierre and Pauline Soms Vault in Holy Cross Cemetery, San Mateo County, California; said vault is presumably to be cared for under a contract providing for perpetual care thereof, but if, for any reason, said vault should not be properly cared for, the Trustee is urged to and authorized to make any necessary repairs thereto.

(b) Out of any undistributed income and/or principal of the trust fund and estate, the Trustee shall make the following payments: [A direction for payment of \$104,000 to specific individuals.] [32]

(c) Out of the net income of the trust fund and estate not required for any of the purposes aforesaid, the Trustee shall make the following

payments: [A direction for payment of annuities aggregating \$600 per month.]

(d) The Trustee shall pay over all of the net income of the trust fund and estate, not required for any of the purposes aforesaid, in perpetuity, as follows: [A direction is made for the payment of the income in equal shares to six organizations qualifying as charitable organizations under the applicable provisions of the Revenue Act.]

* * * * *

Article IX.

The Trustee shall be compensated for its services as follows:

* * * * *

(e) Reasonable compensation to the Trustee for any extraordinary services performed by it in defending the Trust or the trust estate, or the interest of any beneficiary hereunder, including the costs and expenses of the Trustee in so doing.

John Tonningsen died November 28, 1933. At that time respondent valued the assets of the trust at \$702,222.51. From that time until the date of her death on January 25, 1936, Pauline Tonningsen resided at the Hotel St. Frances, San Francisco, California, with her niece, Louise Weyer. They occupied a suite of four rooms, for which Pauline Tonningsen paid the rent.

Prior to her husband's death Pauline Tonningsen had been paralyzed and from the date of his death

until her own death she was confined to her bed and wheel chair. She was under constant care of physicians and had nurses continually in attendance. She was 81 years old when her husband died. The hotel books showed expenses incurred by her of \$1,338.98 for November and December 1933; \$8,210.22 for 1934; \$8,744.05 for 1935; and \$723.91 for January 1936. The above sums were for rent and meals for herself and Louise Weyer. She had no servants other than the hotel afforded and did not entertain except to receive her close friends.

Pauline Tonningsen's bills for physicians' services totaled \$635, \$796 and \$122 for the years 1934, 1935, and 1936, respectively.

After the death of John Tonningsen all of the income of the trust was paid to Pauline Tonningsen. Beginning February 1934, the trustee paid Pauline Tonningsen an amount of \$5,000 per month without regard to the income received by the trust, the charities who were the remaindermen of the trust having given their consent. The agreement was renewed in December 1934, and again on April 3, 1935, for a period of one year from March 1, 1935, or a shorter period in the event of Pauline Tonningsen's death. The trustee had objected to making the payments unless it was held harmless by the remaindermen. By reason of this arrangement total payments out of the corpus amounting to \$16,614.53 were made in 1934 and \$9,545.80 were made in 1935. [33]

At the time of her death on January 25, 1936, at the age of 83 years, 7 months, and 3 days, Pauline

Tonningsen had an individual separate estate subsequently appraised at \$87,046.67 and bank accounts in joint tenancy with Louise Weyer in the sum of \$103,067.06.

Louise Weyer was the recipient of Pauline Tonningsen's estate, bank accounts in joint tenancy, and gifts in contemplation of death in the total sum of \$161,745.92. Pauline Tonningsen had no children. She had other relatives by blood and marriage but did not remember them in her will.

Petitioner paid out for the maintenance of the cemetery vault designated in the trust indenture the amount of \$200. On July 26, 1936, the Superior Court of San Francisco County decreed that the clause of the trust providing for the care and upkeep of the cemetery vault was invalid and authorized the trustee to hold the trust free of any obligation to keep up and repair the vault.

The trust estate was composed of real and personal property and yielded net income as follows:

1931	\$70,970.00
1932	73,984.18
1933	47,693.67
1934	45,571.58
1935	45,938.85

Petitioner filed a return for 1935 on a cash basis. During that year, in addition to other income, is realized the sum of \$32,785.40 as taxable income from capital gains.

During 1936 petitioner realized gross taxable income of \$74,989.57. Respondent concedes deductions

of \$3,146.74 miscellaneous expenses and \$43,450.17 capital gains permanently set aside for charitable organizations.

A deficiency in estate tax was proposed against the executors of the estate of John Tonningsen and the executors sought to have the petitioner pay all or part thereof out of the trust property, contending that the trust was liable for all or part of the Federal tax due from the estate by reason of the inclusion in the gross estate of the corpus of the trust because of the provision for payment of estate tax appearing in article VII (a) of the trust agreement. The trustees denied liability on the ground that the payments specified in Article VII (a) were to be made upon the death of the survivor of the trustors, and, Pauline Tonningsen still being alive, no payments could be made. A similar issue arose under the California estate tax. The trustees realized they might be liable, so they employed counsel and sought to be recognized by the Commissioner as a tax- [34] payer and evidenced a willingness to pay their share of the tax. A reduction was obtained in the amount of the deficiency. In determining the amount of the deficiency a deduction of \$472,672.74, being the value of the remainder interest in the corpus, was allowed as permanently set aside for charitable uses.

After Pauline Tonningsen's death and on June 12, 1936, the executor of the estate of John Tonningsen and the petitioner herein reached an agreement relative to the amount of Federal and California

estate taxes which the trustees would pay, which was two-thirds of the deficiency, plus interest. Consent to this agreement and a waiver of any claims against the trustees were made by the charities which were the remaindermen.

On June 30, 1936, petitioner paid the executors of the estate of John Tonningsen, pursuant to the above mentioned agreement, on account of Federal estate taxes, \$15,616.24, being two-thirds of the deficiency, and \$1,436.70, being two thirds of the interest thereof, together with \$1,480.92, being two-thirds of the California estate tax. This, petitioner charged to principal on its records. The executors paid the deficiency and interest in June 1936.

The sum of \$7,500 was paid to the attorney representing the petitioner in connection with the dispute over the estate tax liability. This was charged to income on the records of the trust and taken as a deduction from gross income on the fiduciary return for the year 1936.

In July and December of 1936, petitioner paid to charities designated in the trust instrument the total sum of \$17,178.44, which amounts were charged against income on the records of the trust.

During 1936 petitioner also made payments totaling \$102,000 under article vii (b) of the trust indenture to parties named therein, which payments were charged to principal on petitioner's records.

Petitioner filed a return for the year 1936 on Form 1041. Its gross income for that year was in

excess of \$5,000. No return on Form 1040 was ever filed by petitioner for the year 1936.

In determining the deficiency for 1936, respondent allocated the payments of estate tax and attorneys' fees between taxable and tax-exempt income and denied the deduction for payment to charitable institutions of the proportionate amount.

Opinion.

Oppe: The first question is whether capital gains of the petitioner trust concededly allocable to corpus under California law were so "paid or permanently set aside" for charitable purposes as to [35] be exempt from income tax under Revenue Act of 1934, section 162 (a).¹

There is no contention that any amounts were actually paid, and the question arises by reason of

¹Sec. 162. Net Income.

The net income of the estate or trust shall be computed in the same manner and on the same basis as in the case of an individual, except that—

(a) There shall be allowed as a deduction (in lieu of the deduction for charitable, etc., contributions authorized by section 23 (o)) any part of the gross income, without limitation, which pursuant to the terms of the will or deed creating the trust, is during the taxable year paid or permanently set aside for the purposes and in the manner specified in section 23 (o), or is to be used exclusively for religious, charitable, scientific, literary, or educational purposes, or for the prevention of cruelty to children or animals, or for the establishment, acquisition, maintenance or operation of a public cemetery not operated for profit;

*

*

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*

*

provisions in the trust instrument granting to certain individuals such rights to income and possibly to principal as to cause the parties to disagree whether it can be said that the capital gains in question were permanently set aside for the use of the charities, so as to be beyond the reach of distribution to the individual beneficiaries and thus to comply with the requirements of section 162 (a).

A cognate question has arisen from time to time as to exemption from estate tax under Revenue Act of 1926, section 303 (a) (3), and similar provisions of other acts. See e. g. *Ithaca Trust Co. v. United States*, 279 U. S. 151. It is suggested that the tendency in considering such cases has been for the courts to ascertain as nearly as may be the extent to which a gift may reasonably be considered as destined for charitable purposes and to permit the exclusion of an estimated value thereof as the nearest approximation that can be made to a necessarily final result. See *Boston Safe Deposit & Trust Co. v. Commissioner* (C. C. A., 1st Cir.), 66 Fed. (2d) 179, 184; certiorari denied, 290 U. S. 700.

In cases dealing with income, however, where questions identical to that now before us were involved, a more rigorous approach has been adopted on occasion, and the deduction has been denied unless enjoyment by the charitable beneficiaries is shown to be almost certain and virtually inevitable. See e. g. *Bank of America National Association, Trustee*, 19 B. T. A. 1273; *Gertrude Hemler Tracy et al., Trustees*, 30 B. T. A. 1156; *Guaranty Trust*

Co. of New York, Executor, 31 B. T. A. 19; Old Colony Trust Co., Trustee, 33 B. T. A. 311. But see Helen G. Bonfils et al., Executors, 40 B. T. A. 1079; *affd.* (C. C. A., 10th Cir.), ——— Fed. (2d) ——— (Nov. 6, 1940). See also Union Trust Co. of Pittsburgh v. Commissioner (C. C. A., 3d Cir.), ——— Fed. (2d) ——— (Sept. 27, 1940).

Whether or to what extent the two rules are in fact different, however, or which of them is more properly applicable to such a case [36] as this, we find it unnecessary to decide. For even if we adopt the approach suggested by petitioner and endeavor to determine, on the basis of the probabilities as they existed in the years involved, the reasonable likelihood that these capital gains were protected from invasion in favor of the individual beneficiaries, we are forced to conclude that the weight of evidence is contrary to petitioner's contention. Likelihood that corpus would be devoted to non-charitable purposes appears from the most cogent of circumstances, the compelling logic of actual events. It is shown that in all the relevant years such large payments were made to the individual beneficiary that a substantial amount in each year was taken from the corpus. And of course if it happened in one year there is the more reason for expecting a repetition. There is no indication that the years before us were exceptional or that the needs of the individual beneficiary were greater or the trust income less than could be anticipated in any typical period. It follows that petitioner has

failed to show that the corpus, of which these capital gains became an indistinguishable part, was so protected from invasion as to enable us to say that they were permanently set aside for the benefit of the charities. The evidence indicates the contrary.

Petitioners contend that since this invasion of corpus had the consent of the remaindermen, the charitable institutions, it is no proof that the life tenant was within her legal rights in demanding the payments from corpus. This may or may not be true, since the consent of the beneficiaries in despite of their financial interest might well proceed from a recognition on their part that a litigated contest would result unfavorably to them. But, be that as it may, our question is "a factual one", *Helen G. Bonfils, supra*; not what were the legal rights of the parties but what were the actual probabilities. And if the consent of the remaindermen to the invasion of corpus was obtained in one year, there would be no reason to assume that it would not be forthcoming, as in fact it was, in the next. It is unnecessary to add that there were also individual remaindermen for the payment of whose specified shares corpus would have to be used. See *Bank of America National Association, Trustee, supra*. We conclude that the capital gains which were added to corpus in 1935 can not be said to have been paid or permanently set aside for charitable purposes.

For the year 1936 a different question arises. Payments of estate tax on the estate of the grantor of the trust and of attorneys' fees were made by petitioner, the former being charged to corpus. An amount equal to the income of the trust was paid as such to the charitable organizations, and is claimed as a deduction in the full amount under section 162 (a). It is respondent's position in dis-[37] allowing that deduction that the payments of estate tax and attorneys' fees were actually payments out of income and to the extent thereof reduced the current income available for distribution to the charities, so that in effect what was paid to them was in reality not income but corpus and hence not deductible.

The deduction which is permitted is of "any part of the gross income, without limitation, which, pursuant to the terms of the will or deed creating the trust, is during the taxable year paid" for charitable purposes. If, as respondent contends, the parts of the gross income in question were not, pursuant to the deed creating the trust, paid to the charities, the deduction would not be available. The issue, therefore, narrows to the question whether the trust instrument provided that the payments of estate taxes and attorneys' fees should be made from income or whether it directed that the income should be used for the payments to charity.

According to the deed of trust the payments to the charitable institutions were to be the net income "not required for any of the purposes afore-

said." This is provided by article vii (d). Article vii (a) requires the trustee "out of the income of the trust fund and estate, if that be sufficient, or out of the principal thereof, if necessary" to pay "the inheritance tax upon the distributive shares of or interests in the trust fund and estate, if any be due, and any Federal estate tax due upon the whole thereof and the costs and expenses of the trust."

These provisions appear to be so clear as to offer small room for construction. The income of the trust for the year 1936 was sufficient to pay the estate taxes and attorneys' fees in question. The trust deed requires that under those circumstances they be paid out of that income. It provides for the distribution to the charities of only the income not so required, thus precluding any distribution to them "pursuant to the terms of the will or deed creating the trust" of income which had already been used pursuant to those terms for other purposes. The deduction in question accordingly finds no support in section 162 (a). See *Old Colony Trust Co., Trustee*, *supra*.

It is not entirely clear whether the payment of attorneys' fees is also claimed as a deduction on the ground of ordinary and necessary business expense. Such a claim, if made, must be denied in the complete absence of any showing that the trust was engaged in a trade or business. *Deputy v. Dupont*, 308 U. S. 488; *White Trust v. Commissioner* (C. C. A., 3d Cir.), ——— Fed. (2d) ——— (Oct. 9, 1940).

The final issue involves the proposed imposition of a penalty for petitioner's failure to file a return. The question raised is whether omission to file Form 1040 covering taxable net income of the trust, [38] although concededly Form 1041, the information return, was duly filed, subjects petitioner to the penalty imposed by section 291 of the Revenue Act of 1936.²

The penalty is for failure to file a return "required by this title." Section 142 entitled "Fiduciary Returns" requires "every fiduciary" to "make under oath a return for * * * (4) every estate or trust the net income of which for the taxable year is \$1,000 or over; (5) every estate or

²Sec. 291. Failure to File Return.

In case of any failure to make and file return required by this title, within the time prescribed by law or prescribed by the Commissioner in pursuance of law, unless it is shown that such failure is due to reasonable cause and not due to willful neglect, there shall be added to the tax: 5 per centum if the failure is for not more than thirty days with an additional 5 per centum for each additional thirty days or fraction thereof during which such failure continues, not exceeding 25 per centum in the aggregate. The amount so added to any tax shall be collected at the same time and in the same manner and as a part of the tax unless the tax has been paid before the discovery of the neglect, in which case the amount so added shall be collected in the same manner as the tax. The amount added to the tax under this section shall be in lieu of the 25 per centum addition to the tax provided in section 3176 of the Revised Statutes, as amended.

trust the gross income of which for the taxable year is \$5,000 or over." Nothing is said as to the form on which the return must be filed and there is no contention here that the respondent was not given all the necessary information on the form which the petitioner filed. Under the respondent's regulations³ it is by no means clear that more than one return was required in the present case, nor on which form the income should be returned by the fiduciary. It is clear that a return on Form 1041 would be required if deductions were sought under sections 162 (b) or (c), but the deductions claimed by petitioner were those described in section 162 (a), a situation as to which the regulations are

³Art. 142-1. Fiduciary returns.—Every fiduciary, or at least one of joint fiduciaries, must make a return of income—

* * * * *

(b) For the estate or trust for which he acts if the net income of such estate or trust is \$1,000 or over, or if the gross income of the estate or trust is \$5,000 or over, regardless of the amount of the net income, or if any beneficiary of such estate or trust is a nonresident alien.

The return in case (a) shall be on Form 1040 or 1040A. In case (b) a return is required on Form 1040 with respect to any taxable net income of the estate or trust computed in accordance with section 162 and a return on Form 1041 with respect to any income deducted under section 162 (b) or (c). If a portion of the income of the estate or trust is retained by the fiduciary and the remainder is distributable or distributed to beneficiaries, both Forms 1040 and 1041 will be required. * * *

silent. Nor, on the theory of either party to this proceeding, would the case fall within the condition that a portion of the income is retained by the fiduciary and the remainder distributed, since on petitioner's theory none of the taxable income was retained and, on the respondent's, all. We are accordingly unable to say that the missing return was required by the specified title of the revenue act, even though its provisions be amplified by reference to respondent's regulations. That being so, the necessary prerequisite for the application of the [39] penalty provision is absent. See *American Circus Joint Venture*, 39 B. T. A. 605. We do not purport to pass upon a case disclosing a failure to file a return clearly called for by the statute or even by respondent's regulations, whether or not that return is an additional return to one otherwise required. See *Collateral Mortgage & Investment Co.*, 37 B. T. A. 630; *Lone Pine Lawn Corporation*, 41 B. T. A. 638. Questions of that kind must be left open for determination on a record and under circumstances more favorable to respondent's contention than those appearing here.

Decision will be entered under Rule 50. [40]

EXHIBIT D

United States Board of Tax Appeals
Washington

Docket No. 99280

JOHN AND PAULINE TONNINGSEN TRUST,
BANK OF AMERICA NATIONAL TRUST
& SAVINGS ASSN. TRUSTEE,
Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

DECISION

Pursuant to the Board's Findings of Fact and Opinion, promulgated December 19, 1940, the respondent herein having on January 4, 1941, filed a recomputation of tax, and the petitioner having on January 28, 1941, filed an acquiescence in said recomputation, now, therefore, it is

Ordered and decided: That there are deficiencies in income tax for the calendar years 1935 and 1936 in the respective amounts of \$4,610.65 and \$1,713.74, and no penalty for the year 1936.

Enter:

[Seal] (Signed) CLARENCE V. OPPER,
Member.

Entered Jan. 31, 1941. [41]

EXHIBIT E

“(PETITIONER’S EXHIBIT 9)”

John L. McNab

Attorney at Law

Crocker First National Bank Bldg.

San Francisco

December 26, 1934.

San Francisco Unit of the American Red Cross,
San Francisco, California.

Dear Sirs:

I recall to your attention the fact that John Tonningsen before his death established a trust of about half a million dollars with the Bank of America for six beneficiaries, of which you are one.

In reality this was not John Tonningsen’s property. It was the property of his wife. She was inclined to attack the trust and had she done so would probably have been successful. She was persuaded not to engage in litigation.

The Bank agreed for one year to pay her \$5,000.00 per month, regardless of the amount of the income. The income is now something like \$2200.00 per month. That year has expired.

Mrs. Tonningsen is bedridden and has been trying to build up a fund to take care of certain relatives of hers whom John Tonningsen excluded under his Will to her bitter disappointment.

The Bank of America has decided that it will pay her only the net income, but has agreed to continue

to pay the \$5,000.00 per month for another year if the charities, who are the beneficiaries, will consent.

Mrs. Tonningsen has just passed through a desperate illness, which we thought she could not survive. She is now only a frail little wisp of a woman and cannot, at best, long survive. She is constantly worried by the action of the Bank and frets continuously. She calls me several times a week to know if the matter has been arranged.

In short, the situation that I put to you is this:

You are the recipient of a large benefaction that came from her property.

I cannot believe it possible that Mrs. Tonningsen [42] can survive the year upon which we are about to enter.

She is entitled, under the trust, to the net income. The added income would amount to about \$2700.00 a month.

I feel that the charities who are receiving all of this as a benefaction will consent to the Bank continuing, for the forthcoming year, but no longer, the arrangement followed during the past year, namely, the payment of \$5,000.00 per month. This, of course, would end immediately on her death.

I put this matter plainly before you and ask you for your consent to the Bank of America continuing the arrangement which has been followed since John Tonningsen's death during the forthcoming year, or until her earlier death.

I am sure that by doing so you will not only re-

lieve her mind from constant worry, but would be merely performing the part of a real charity.

Yours very respectfully,
(Signed) J. L. McNAB. [43]

EXHIBIT F

“(PETITIONER’S EXHIBIT 5)”

BANK OF AMERICA NATIONAL TRUST
AND SAVINGS ASSOCIATION,

Trust Department,
485 California Street,
San Francisco, California.

April 3, 1935

Subject: Your San Francisco Trust No. 1438,
John Tonningsen, deceased,

Reference is hereby made to that certain Trust Agreement dated August 7, 1930, executed by and between John Tonningsen and Pauline E. Tonningsen, as Trustors, and Bank of Italy National Trust and Savings Association, (now Bank of America National Trust and Savings Association) as Trustee, and to the trusts therein declared and set up.

Whereas said John Tonningsen died on November 28, 1933, and by the terms of said Trust Agreement the net income from said trust has been since the death of said John Tonningsen and now is payable to Pauline E. Tonningsen as surviving Trustor; and

Whereas by the terms of said Trust Agreement

it is further provided that should the net income from the trust be insufficient for the proper support, care and maintenance of said Pauline E. Tonningsen that the Trustee may, in its absolute discretion, pay to her out of the principal of the trust fund and estate such additional amounts as it may deem necessary and appropriate therefor; and

Whereas said Pauline E. Tonningsen has requested the payment to her from income and/or principal of the trust estate the sum of Five Thousand Dollars (\$5,000.00) monthly, stating that said payments are necessary for her proper support, care and maintenance; and

Whereas the present net income from the trust is insufficient to provide for such payments and it will be necessary in order to make such payments for the Trustee to augment the net income from the trust estate by payments from the principal thereof; and

Whereas the undersigned charitable organizations by the terms of the Trust Agreement above referred to are now vested with the right to the income of the trust in perpetuity subsequent to the death of Pauline E. Tonningsen, save and except certain annuities payable to individuals; and [44]

Whereas the undersigned charitable organizations have signified their consent to the withdrawal from the principal of the trust estate of sufficient amounts to augment the income from the trust estate so as to assure the payment to Pauline E. Tonningsen of Five Thousand Dollars (\$5,000.00) monthly for the

period of one year commencing March 1, 1935, or until her death should she die prior to the expiration of said period, and have further approved, ratified and confirmed all payments from the principal of the trust estate heretofore made by the Trustee to said Pauline E. Tonningsen in addition to the payment to her of the net income of the trust;

Now, therefore, the undersigned charitable organizations hereby approve of and consent to the payment by the Trustee from the principal of the trust estate of such amounts as which together with the net income of the trust will provide for a monthly payment to said Pauline E. Tonningsen of Five Thousand Dollars (\$5,000.00) for the period of one year commencing March 1, 1935, or until the death of said Pauline E. Tonningsen, should she die prior to the expiration of said period and hereby ratify, approve and confirm all payments heretofore made by the Trustee to said Pauline E. Tonningsen from the principal of the trust estate and, in consideration of said payments of principal made and to be made by said Trustee to said Pauline E. Tonningsen, hereby jointly and severally release the Trustee from any and all liability to the undersigned, or any of the, by reason of the said payments, herein re-

ferred to, so made or to be made to the said Pauline E. Tonningsen.

SHRINERS HOSPITAL FOR
CRIPPLED CHILDREN,

By

By

MASONIC HOMES OF
CALIFORNIA,

By

By

BOY SCOUTS OF AMERICA,

By

By

SAN FRANCISCO
COMMUNITY CHEST,

By

By

SAN FRANCISCO TUBER-
CULOSIS ASSOCIATION,

By

By

SAN FRANCISCO CHAPTER,
AMERICAN RED CROSS,

By (Signed) W. H. AVERY

By [45]

EXHIBIT G

PRINCIPAL ACCOUNT—1935

Comm'r of Internal Revenue

51

		Disbursed	Received Cost	Received Gain
Jan. 2	On Hand	\$	\$ 2,711.17	\$
Feb. 5	Sale of Bonds.....		31,925.00	2,525.00
13	Reinvested	35,807.50		
Mar. 18	Attorney's Fees	100.00		
21	Sale of Bonds.....		2,400.00	1,170.00
25	State Inheritance Tax.....	4,216.48		
Apr. 13	Sale of Bonds.....		3,172.50	245.91
18	Pauline E. Tonningsen.....	3,384.47		
30	Pauline E. Tonningsen.....	2,189.62		
May 2	Sale of Bonds.....		2,115.00	129.18
15	Amortization of Premium.....		2.82	
27	Sale of Bonds.....		2,115.00	106.86
31	Pauline E. Tonningsen.....	2,304.24		
June 15	Amortization of Premium.....		18.40	
July 31	Pauline E. Tonningsen.....	634.40		
Aug. 29	Sale of Bonds.....		1,057.50	65.00
31	Pauline E. Tonningsen.....	1,032.07		
Oct. 7	Sale of Bonds.....		19,000.00	32,501.00
10	Reinvested	50,500.63		
30	Sale of Bonds.....		3,600.00	1,740.00

		Disbursed	Received Cost	Received Gain
Nov. 8	Reinvested	6,131.25		
13	Sale of Bonds.....		2,400.00	1,160.00
15	Amortization of Premiums.....		5.26	
16	Attorney's Fees .....(1)	500.00		
22	Reinvested	3,044.06		
30	Pauline E. Tonningsen.....(2)	1,216.20		
Dec. 4	Sale of Stock.....		650.00	503.47
11	Sale of Stock.....		650.00	615.97
13	Adjustment .....(2)	[1,216.20]		
16	Amortization of Premiums.....		53.32	
20	Reinvested	2,027.50		
26	Sale of Stock.....		650.00	565.97
30	Reinvestment	1,016.88		
Total.....		\$112,889.10	\$ 72,525.97	\$ 41,328.36
Balance Dec. 31, 1935.....			\$ 965.23	
Adjustment July 9, 1936 (1).....		[\$500.00]		
Unrecognized gain				\$ 8,542.96
Recognizable gain				\$ 32,785.40

Notes: (1) \$500.00 paid to attorney was charged back to the income account in 1936.
 (2) \$1,216.20 paid to Pauline E. Tonningsen was charged back to income.

EXHIBIT H

1936

INCOME, DEDUCTIONS, ETC.

	Income Account	Return	Audit
Net Rentals—Less Commissions.....	\$ 30,764.40	\$ 30,764.40	\$ 30,764.40
Dividends	775.00	775.00	775.00
Capital Gains		43,450.17	43,450.17
Total Taxable Income.....		\$ 74,989.57	\$ 74,989.57
Less—Gains, set aside.....			\$ 43,450.17
Balance	\$ 31,539.40		\$ 31,539.40
Less Conceded Deductions (1).....	3,147.74	3,146.74	3,146.74
Balance	\$ 28,391.66	\$ 71,842.83	\$ 28,392.66
Net Exempt Income—less interest paid and amortiza- tion of Bond Premium (2).....	10,591.02	[10,597.02]	10,597.02
On Hand, Jan. 1, 1936.....	2,417.99		
Balance of Ordinary Income.....	\$ 41,400.67	\$ 71,842.83	\$ 38,989.68
Attorneys Fees	\$ 7,500.00	\$ 7,500.00	Disallowed
Net Income on Return.....		\$ 64,342.83	\$ 64,342.83

	Income Account	Return	Audit
Pauline E. Tonningsen.....	\$ 5,000.00	\$ 5,000.00	\$ 3,641.00
Individual Beneficiaries	6,600.00	6,600.00	4,806.12
Charitable Beneficiaries	17,178.45	52,742.83	987.31
Repair of Vault.....	200.00		
Transferred to principal on death of Pauline			
E. Tonningsen	4,922.22		
Exempt Income*			10,597.02
Total Deductions, etc.....	\$ 41,400.67	\$ 64,342.83	\$ 20,031.45
Net Taxable Income.....		\$ 0	\$ 18,958.23

*The Exempt Income was pro-rated by the commissioner as follows:

	Total	Taxable	Exempt	Net
Pauline E. Tonningsen.....	\$ 5,000.00	\$ 3,641.00	\$ 1,359.00	See above
Individual Beneficiaries	6,600.00	4,806.12	1,793.88	“ “
Charitable Beneficiaries	1,355.82	987.31	368.51	“ “
Attorneys Fees	7,500.00	5,461.60	2,038.40	\$ 5,461.60
Estate of John Tonningsen.....	18,533.86	13,496.63	5,037.23	13,496.63
	\$38,989.68	\$28,392.66	\$10,597.02	\$18,958.23

[47]

ANALYSIS OF PRINCIPAL ACCOUNT

	Account	Return	Audit
Realized from Sales (3).....	\$142,301.28	\$142,254.78	\$142,254.78
Amortization of Bond Premiums.....	272.20		
Execution of Lease.....	1.00		
From Income on Death of P. E. T.....	4,922.22		
From Income for Attorney's Fees.....\$ 1,500.			
Less charge for same.....1,000.	500.00		
On Hand, Jan. 1, 1936.....	965.23		
Total Principal Receipts.....	<u>\$148,961.93</u>	<u>\$142,254.78</u>	<u>\$142,254.78</u>
Cost of Securities Sold.....			
Unrecognized Gain.....	\$	\$ 69,837.73	\$ 69,837.73
Reinvested.....	29,132.28	28,966.88	28,966.88
Individual beneficiaries.....\$10,200.			
Less charge back.....2,000.	100,000.00		
Trustees fees and expense.....	1,010.50		

	Account	Return	Audit
Estate of John Tonningsen			
Federal Estate Tax—principal.....	15,616.24		
Federal Estate Tax—interest.....	1,436.70		
Calif. Inherit. Tax—principal.....	1,480.92		
			The commissioner contends that \$18,533.86 should have been charged to income.
Calif. Inherit. Tax—interest.....	113.90		
Federal Estate Tax—interest.....	43.00		
On Hand, Dec. 31, 1936.....	128.39		
Total	<u>\$148,961.93</u>	<u>\$ 98,804.61</u>	<u>\$ 98,804.61</u>
Taxable Gain		<u>\$ 43,450.17</u>	<u>\$ 43,450.17</u>

Notes: (1) \$1.00 of miscellaneous expense was apparently inadvertently omitted from the return.
 (2) \$6.00 was apparently erroneously added to the exempt income shown on the return.
 (3) \$28.50 accrued interest was erroneously included in the amount received shown as the return and \$75.00 was erroneously omitted therefrom, leaving a net difference of \$46.50.

EXHIBIT I
(PETITIONER'S EXHIBIT 6)

This Agreement, made and entered into the 12th day of June, 1936, by the Bank of America National Trust & Savings Association, Trustee of the "John and Pauline E. Tonningsen Trust" (Trust No. 1438), hereinafter called the "Trustee", and Hugh W. Campbell, surviving Executor of the last will and testament of John Tonningsen, deceased, hereinafter called the "Executor",

Witnesseth:

Whereas, by letter, dated April 13th, 1936, the Bureau of Internal Revenue has tentatively determined the Federal estate tax liability of the above named estate, determining a deficiency in the amount of \$25,645.74; and whereas, said Executor has acquiesced in said determination, and has waived the restrictions on the assessment and collection of said deficiency and consented to the assessment and collection thereof; and

Whereas, prolonged controversy has existed between the parties hereto with respect to liability for the payment of the Federal estate tax due in the Estate of John Tonningsen, deceased; and

Whereas, said parties desire a speedy and final determination of the Federal estate tax in the Estate of John Tonningsen, deceased, and with respect to the trust above referred, in accordance with the tentative determination above mentioned, and desire

further to amicably adjust the controversy above referred in order to avoid the expense and uncertainty of delay and litigation;

Now, therefore, in consideration of the premises and of the mutual promises of the parties hereinafter [49] contained, it is hereby agreed as follows:

(1) Conditional upon final determination and assessment of the Federal estate tax in the Estate of John Tonningsen, deceased, in conformity with said letter of April 13th, 1936, viz., in the amount of \$25,645.74, or thereabouts, the Executor shall pay one-third ($\frac{1}{3}$) of said deficiency and of any interest required to be paid thereon, and the Trustee shall pay, at the time required for payment thereof, to the Executor two-thirds ($\frac{2}{3}$) of said deficiency and of any interest required to be paid thereon, said amount so received to be applied by said Executor to the payment of said tax.

(2) The term "Federal estate tax" as used in this agreement includes the amount thereof payable to the State of California as an estate tax, with which the Federal estate tax is entitled to credit.

(3) It is expressly agreed and understood that this agreement is intended by way of compromise between the Trustee and the Executor of the controversy above referred to, is expressly limited thereto and shall not constitute, or be deemed, or be used in any proceedings as, an admission on the part of the Trustee of liability, nor preclude the Trustee from hereafter denying any liability, for payment, reimbursement, or contribution of any tax

whatever under any circumstances, except liability for payment by way of compromise pursuant to and subject to the terms and conditions of this agreement.

(4) On the part of the Executor this agreement is conditional upon and subject to the confirmation and [50] approval thereof by the Probate Court in the estate of John Tonningsen, deceased, to be applied for by the Executor promptly upon the execution of this agreement, certified copy of the order of approval and confirmation to be furnished the Trustee in evidence thereof. On the part of the Trustee this agreement is conditional upon and subject to assent thereof by the charitable beneficiaries of the trust, in writing, in terms satisfactory to the Trustee, in evidence of which said Trustee shall furnish the Executor with a letter advising of its receipt of such satisfactory instrument.

(5) The Executor agrees to take no action to reopen the above tax determination, except with the consent of the Trustee, but if there prove to be a right to refund of the tax or any part thereof paid pursuant to the terms of this agreement, the Executor will, upon demand of the Trustee, and only with its consent, apply therefor and pay to the Trustee two-thirds ($\frac{2}{3}$) of any refund so recovered.

(6) The Executor agrees to cooperate with the Trustee and use its best effort to procure from the Bureau of Internal Revenue the certificate offered by it in its letter of June 5th, 1936, releasing said Trustee from liability for any further estate tax in so far as the Trust is concerned.

It witness whereof, the parties hereto have set their hands the day and year first hereinabove written.

BANK OF AMERICA NATIONAL
TRUST & SAVINGS ASSOCIA-
TION, Trustee,

O.K. E.K.L. By R. O. KWAPIL

O.K. L.J.R. Assistant Trust Officer

HUGH W. CAMPBELL

Surviving Executor of the last
will and testament of John
Tonningsen, deceased [51]

EXHIBIT J

(PETITIONER'S EXHIBIT 6)

San Francisco, California,
June 12, 1936

Whereas, the Bank of America National Trust & Savings Association, Trustee of the "John and Pauline E. Tonningsen Trust" (Trust No. 1438), is about to enter into a written agreement with Hugh W. Campbell, surviving Executor of the last will and testament of John Tonningsen, deceased, as of the date hereof, copy of which agreement is attached hereto, hereby referred to, and made a part hereof, the undersigned, a charitable beneficiary named in the John and Pauline E. Tonningsen Trust above referred to, does hereby assent to and concur in the execution and performance thereof by said Trustee

and waives any and all objection on its part thereto. And the undersigned does hereby release and forever discharge the said Trustee of all and from all claims, demands actions and causes of action whatsoever in law or in equity that it may have or hereafter can, shall, or may have for, upon, or by reason of the execution and performance thereof by the said trustee, and does hereby agree to hold said Trustee harmless against any claim by it because of the execution or performance of said agreement.

In witness whereof, the undersigned has caused this instrument to be duly executed by its officer or representative thereunto duly authorized, as of the day and year first above written.

THE IMPERIAL COUNSEL OF THE
ANCIENT ARABIC ORDER OF THE
[Seal] NOBLES OF THE MYSTIC SHRINE
FOR NORTH AMERICA, a corporation
By LEONARD P. STEUART

Its President

and by JAMES H. PRICE

Its Secretary.

Leo J. Rabinowitz

Attorney at Law

Mills Building

San Francisco [52]

[Title of Board and Cause.]

CERTIFICATE

I, B. D. Gamble, Clerk of the U. S. Board of Tax Appeals, do hereby certify that the foregoing pages 1 to 52, inclusive, contain the record on appeal as agreed to by the parties in accordance with Rule 76 of the Rules of Civil Procedure for the District Courts of the United States.

In testimony whereof, I hereunto set my hand and affix the seal of the United States Board of Tax Appeals, at Washington, in the District of Columbia, this 29th day May, 1941.

[Seal]

B. D. GAMBLE

Clerk, United States Board
of Tax Appeals.

[Endorsed]: No. 9837. United States Circuit Court of Appeals for the Ninth Circuit. Bank of America National Trust and Savings Association, Trustee of the John and Pauline Tonningsen Trust, Petitioner, vs. Commissioner of Internal Revenue, Respondent. Transcript of the Record. Upon Petition to Review a Decision of the United States Board of Tax Appeals.

Filed June 3, 1941.

PAUL P. O'BRIEN,

Clerk of the United States Circuit Court of Appeals for the Ninth Circuit.

In the United States Circuit Court of Appeals
for the Ninth Circuit

No. 9837

JOHN AND PAULINE TONNINGSEN TRUST,
BANK OF AMERICA NATIONAL TRUST
& SAVINGS ASSOCIATION, Trustee,
Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

STATEMENT OF POINTS RELIED UPON ON
APPEAL AND DESIGNATION OF RECORD

Petitioner hereby adopts as its points upon appeal, pursuant to paragraph 6 of rule 19 of the above entitled court, the points set forth in its "Statement of Points to be Relied Upon on Appeal" contained in the "Agreed Statement of the Proceedings on Review" heretofore filed herein, and more particularly designated therein as "Exhibit B".

And petitioner hereby designates the entire transcript as necessary for the consideration of said appeal.

Dated, June 5, 1941.

J. W. RADIL

F. J. KILMARTIN

Attorneys for Petitioner.

[Endorsed]: Filed June 5, 1941. Paul P. O'Brien,
Clerk.

No. 9837

IN THE

United States Circuit Court of Appeals

For the Ninth Circuit

BANK OF AMERICA NATIONAL TRUST AND
SAVINGS ASSOCIATION, Trustee of the
John and Pauline Tonningsen Trust,
Petitioner,

VS.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

**Upon Petition to Review a Decision of the United States
Board of Tax Appeals.**

BRIEF FOR PETITIONER.

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Subject Index

	Page
Jurisdictional Statement	1
Statement of the Case.....	2
Statutes involved	2
Questions involved and the manner in which they are raised	3
Specification of Errors	8
Argument	11

1935. Summary.

I.

The capital gains realized in 1935 are deductible under the provisions of Section 162(a) of the Revenue Act of 1934..	12
A. Under the provisions of Section 162(a) capital gains are permanently set aside or to be used exclusively for charitable purposes when the gain measured thereby will accrue to charitable purposes.....	12
B. The facts demonstrate that the capital gains realized in 1935 are deductible	25
(1) Neither the actual payments made, nor the discretionary provision of the trust defeat the deduction	26
(a) There is no warrant for a finding that the payments made were made "pursuant to the terms of the * * * deed creating the trust"	28
(b) The evidence shows that the payments were made out of the funds of the charitable remaindermen and not pursuant to the terms of the trust	30
(c) Even if it could be said that the payments were made pursuant to the terms of the trust, the charitable beneficiaries would not be deprived of the benefit of the capital gains	32
(2) The remaining provisions of the trust do not defeat the deduction	33

	Page
II.	
All capital gains except possibly \$3070.62 were actually retained in the trust for the charitable remaindermen.....	34
III.	
If the income is not held for the charitable remaindermen it is taxable to the grantor-life beneficiary of the trust...	36
A. In so far as income was realized by the trust in the form of capital gains and paid to the life beneficiary it was deductible under Section 162(c) of the Revenue Act of 1934	37
B. In so far as income was realized by the trust in the form of capital gains and accumulated for the grantor-life beneficiary, it was taxable to her and not to the trust.....	37
1936. Summary.	
I.	
The amount paid the estate of John Tonningsen was properly paid from the principal of the trust.....	45
A. Petitioner was not required to meet extraordinary charges out of income accruing after the surviving trustor's death	50
B. The payment made was not within the scope of those referred to in Article VII(a).....	54
C. The payment was not made pursuant to the terms of the trust, but aside therefrom.....	56
II.	
The payments for attorneys' fees and to the executors do not represent taxable income, as they are sums paid for charitable purposes	57
Conclusion	58

Table of Authorities Cited

Cases	Pages
Bank of America Nat'l Assn., Trustee, 19 B.T.A. 1273.....	34
Beggs v. United States (Ct. Cl.), 27 Fed. Supp. 599.....	15n
Bowers v. Slocum (C.C.A. 2), 20 F. (2d) 350.....	15n, 17, 21, 26
Canfield, Estate of, 104 Cal. App. 181, 285 P. 363, 28 Cal. Law. Rev. 34, November, 1939.....	13
City Bank Farmers Trust Company v. Helvering, Nos. 408 and 409, April 28, 1941, 85 L. ed. 788.....	7
Colt v. Duggan (S.D., N.Y.), 25 F. Supp. 268.....	17
Commissioner v. Bonfils (C.C.A. 10), 115 F. (2d) 788.....	16, 18, 20, 27, 57
First National Bank v. Snead (C.C.A. 3), 24 F. (2d) 186..	18, 30
Freuler v. Helvering, 291 U.S. 35, 78 L. ed. 634.....	26
Gartenlaub, Estate of, 198 Cal. 204, 244 P. 348.....	13
Hartford Nat'l Bank & Trust Co. v. Hartford Connecticut Trust Co. (D. Conn.), 20 A.F.T.R. 1325.....	19
Hartford Connecticut Trust Co. v. Eaton (D. Conn.), 29 F. (2d) 840	21
Hartford-Connecticut Trust Co. v. Eaton (C.C.A. 2), 36 F. (2d) 710	19, 21, 30
Hartford Connecticut Trust Co. v. Eaton (D. Conn.), 41 F. (2d) 69	19
Helvering v. Clifford, 309 U.S. 331, 84 L. ed. 788.....	5, 37, 38, 43
Irving Bank-Columbia Trust Co., Executor, 8 B.T.A. 833..	15n
Ithaca Trust Co. v. United States, 279 U.S. 151, 73 L. ed. 647	18, 19
Johnson, E. C., Executor, 13 B.T.A. 850.....	15n
Kruce, Estate of, 10 Cal. App. (2d) 426, 51 P. (2d) 1174...	52
Lederer v. Stockton, 260 U.S. 3, 67 L. ed. 99.....	22
Lonsdale, Georgia B., 42 B.T.A. 847.....	40
Lucas v. Mercantile Trust Co. (C.C.A. 8), 43 F. (2d) 39....	18, 30

	Pages
McClung, Hu L., et al., Executors, 13 B.T.A. 335.....	15n
Millard v. Humphrey (W.D., N.Y.), 8 F. Supp. 784 (aff'd C.C.A. 2), 79 F. (2d) 107).....	18, 27, 30
Morehead, Katharine Boyd, 42 B.T.A. 851.....	40
Old Colony Trust Co. v. Commissioner, 301 U.S. 379, 81 L. ed. 1169	49
Peoples Trust Co., Trustee, 10 B.T.A. 1385.....	15
Potter v. Bowers (C.C.A. 2), 89 F. (2d) 687.....	15n
Reinecke v. Smith, 289 U.S. 172, 77 L. ed. 1109.....	39
Rollins v. Helvering (C.C.A. 8), 92 F. (2d) 390 (cert. den. 302 U.S. 763, 82 L. ed. 592).....	38, 40
Slocum, Herbert Jermain, Executor, 6 B.T.A. 36.....	15n
Slocum v. Bowers (S.D., N.Y.), 15 F. (2d) 400.....	15n, 17, 22
Smith, Estate of, 23 Cal. App. (2d) 393, 73 P. (2d) 239....	29
Union Trust Co. of Pittsburgh v. Commissioner (C.C.A. 3), 115 F. (2d) 86, cert. den. March 10, 1941, 85 L. ed. 662..	17
Welch, E. Sohler, et al., Trustees, 9 B.T.A. 1370.....	15n
Wenger, Mary E., 42 B.T.A. 225.....	40
White v. Higgins (C.C.A. 1), 116 F. (2d) 312.....	41, 44
Willson, Francis S., 44 B.T.A. No. 93 (May 27, 1941)..	40

Codes and Statutes

California Civil Code, Section 2269.....	30
California Probate Code, Section 60.....	52
Internal Revenue Code, Section 812(d).....	18
Internal Revenue Code, Section 1101 (Act of Feb. 10, 1939, c. 2, sec. 1101, 53 Stat. 158).....	2
Internal Revenue Code, Sections 1141, 1142 (Act of Feb. 10, 1939, c. 2, Sections 1141, 1142, 53 Stat. 164, 165)....	2
Revenue Acts of 1924 and 1926, Section 213(a) (43 Stat. 267, 44 Stat. 23).....	42
Revenue Acts of 1924 and 1926, Sections 219 (g) and 219 (h) (43 Stat. 277, 44 Stat. 34).....	42

	Pages
Revenue Act of 1934, Sections 53(a)1 and 56.....	34
Revenue Act of 1934, Section 22(a), 23(o), 162, 167 (Act of May 10, 1934, c. 277, Sections 22(a), 23(o), 162 and 167, 48 Stat. 686, 688, 728, 723, 28 U.S.C.A., Internal Revenue Acts, pp. 669, 674, 725, 727).....	
.....2, 3, 5, 8, 11, 13, 14, 16, 17, 34, 37, 38, 42, 43	
Revenue Acts of 1934 and 1936, Section 272 (Act of May 10, 1934, c. 277, Section 272, 48 Stat. 741, and Act of June 22, 1936, c. 690, Section 272, 49 Stat. 1721).....	2
Revenue Act of 1936, Sections 23(o), 162 (Act of June 22, 1936, c. 690, Sections 23(o), 162, 49 Stat. 1658, 1706, 28 U.S.C.A., Internal Revenue Acts, pp. 829, 893) ..	2, 6, 7, 8, 58

Texts

Bogart, Trusts and Trustees, Vol. 4, p. 2351, Section 812...	30
49 Yale Law Journal, 1496, p. 1498.....	17

Rules

Federal Rules of Civil Procedure, Rule 76.....	1
U. S. C. C. A. Rule 30.....	1



No. 9837

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BANK OF AMERICA NATIONAL TRUST AND
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John and Pauline Tonningsen Trust,
Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

Upon Petition to Review a Decision of the United States
Board of Tax Appeals.

BRIEF FOR PETITIONER.

JURISDICTIONAL STATEMENT.

This appeal involves asserted deficiencies in federal income taxes for the taxable years 1935 and 1936 in the respective amounts of \$4610.65 and \$1713.74. The case comes before this Court on petitioner's petition for review (Tr. 15-18) and an agreed statement settled pursuant to Rule 76 of the Federal Rules of Civil Procedure and Rule 30 of this Court (Tr. 1-62), after decision by the United States Board of Tax Appeals entered pursuant to an opinion promulgated December 10, 1940 and reported at 43 B. T. A. 37 (Tr. 25-43).

Jurisdiction of the United States Board of Tax Appeals is based upon Internal Revenue Code, sec. 1101 (Act of Feb. 10, 1939, c. 2, sec. 1101; 53 Stat. 158) and section 272 of the Revenue Acts of 1934 and 1936 (Act of May 10, 1934, c. 277, section 272; 48 Stat. 741, and Act of June 22, 1936, c. 690, section 272; 49 Stat. 1721; see: Internal Revenue Code, section 272). Petitioner, pursuant to said statutes, filed with said Board its petition for a redetermination of the deficiencies proposed by respondent (Tr. 4).

Jurisdiction of this Court is predicated upon Internal Revenue Code, sections 1141 and 1142 (Act of Feb. 10, 1939, c. 2, sections 1141 and 1142; 53 Stat. 164, 165). Petitioner, pursuant to said statutes, filed with said Board its petition for review of the Board's decision (Tr. 2, 15-18).

STATEMENT OF THE CASE.

STATUTES INVOLVED.

Statutes involved for the year 1935 are:

Revenue Act of 1934, section 22(a), 23(o), 162, and 167 [Act of May 10, 1934, c. 277, sections 22(a), 23(o), 162 and 167; 48 Stat. 686, 688, 728 and 723; 28 U.S.C.A., Internal Revenue Acts, pp. 669, 674, 725 and 727].

Statutes involved for the year 1936 are:

Revenue Act of 1936, sections 23(o) and 162 [Act of June 22, 1936, c. 690, sections 23(o) and 162; 49 Stat. 1658 and 1706; 28 U.S.C.A., Internal Revenue Acts, pp. 829 and 893].

The text of these statutes is set forth in an appendix.

QUESTIONS INVOLVED AND THE MANNER IN WHICH
THEY ARE RAISED.

The questions for the respective years 1935 and 1936 present different issues and hereafter will be dealt with separately.

1935.

The chief question in reference to the year 1935 is whether petitioner is entitled to a deduction, under the provisions of section 162(a) of the Revenue Act of 1934, of capital gains realized by it during that year as gross income, which, pursuant to the terms of the deed creating the trust, was, during the taxable year, permanently set aside for or to be used for charitable purposes in accordance with the provisions of said Act.

This question arises by virtue of the inclusion of the sum of \$32,785.40 in the taxable income of petitioner as recognizable capital gains.

During that year petitioner held the assets of the trust, from the sale and reinvestment of which the gains arose, for the benefit of six charitable organizations, subject to the payment of the ordinary income (exclusive of capital gains) therefrom to one life beneficiary thereof during her life and, upon her death, to the payment of charges against the trust estate, to the payment from principal of specific sums to named individuals and to the payment from ordinary income of specific monthly payments during the respective lives of other named individuals. The deed creating the trust also provides:

“Should the said Second Trustor [the life beneficiary] be in need of a greater amount than said net income for her care, maintenance and support, or by reason of illness or other emergency, the Trustee [petitioner] may, in its absolute discretion, pay to her, out of the principal of the trust fund and estate, such additional amounts as it may deem necessary and appropriate for the purposes aforesaid, and no one, howsoever interested in the Trust shall be competent to object thereto.” (Tr. 5, 27-30.)

The ordinary income from the trust estate was over double the existent or possible needs of the life beneficiary for her care, maintenance, and support and for her expenses as an invalid. The charges, and specific bequests payable on the death of the life beneficiary, could by no stretch of the imagination exhaust the trust estate.

There was paid, however, to the life beneficiary sums aggregating \$9545.80 from the principal of the trust estate in 1935. These payments were not made in the exercise of the discretion vested in petitioner, but after its refusal to pay more than the ordinary income, and only with the consent of the charitable remaindermen.

The Board of Tax Appeals held in effect that the fact that payments were actually made from corpus conclusively showed that the capital gains were not deductible. It did not determine whether such payments were made pursuant to the terms of the trust instrument. It did not determine whether the economic benefit represented by the capital gains would

go to the charities pursuant to the terms of the trust. It did not determine whether or not the corpus of the trust, pursuant to the terms thereof and the applicable facts, was free from invasion.

In view of the position taken by the Board of Tax Appeals, petitioner has herein further attempted to show that if the conclusions of the Board are upheld (that is, if the right to the deduction is lost because of actual payments made, regardless of the provisions of the terms of the trust), the income represented by the capital gains was in reality taxable to the life beneficiary of the trust by virtue of the fact that she was also a grantor of the trust. Consequently, if the findings of fact of the Board are sustained, petitioner submits that the income was taxable under section 167 of the Revenue Act of 1934 and under section 22 of the Revenue Act of 1934 and the principles enunciated in the case of *Helvering v. Clifford*, 309 U. S. 331, 84 L. ed. 788. Although this point was not made before the Board of Tax Appeals, the failure of the Board to find on the issues presented and the criteria of judgment followed by the Board make it necessary to raise this point before this Court.

Petitioner, however, chiefly relies upon the point first stated above and has attacked all of the findings of fact and conclusions of the Board and the failure of the Board to find upon issues which it deems relative (Tr. 18-22).

1936.

The questions in reference to the year 1936 are, first, whether, by reason of the provisions of the trust, there should be included in petitioner's taxable income sums paid by it to the legal representative of the estate of the deceased first trustor in satisfaction of a controversy regarding the liability of the trust for contribution for federal estate taxes and state inheritance taxes arising on the death of said trustor and paid by his executors, which said sums petitioner purported to pay out of the principal of the trust, and whether there should be an attendant denial of a deduction under section 162(a) of the Revenue Act of 1936, of amounts which petitioner purported to pay out of income to charitable beneficiaries of the trust; and, second, whether, by reason of the provisions of the trust, there should be included in petitioner's taxable income sums paid by it for legal expenses attendant to securing a reduction in federal estate taxes, which said sums petitioner purported to pay out of the income of the trust.

The life beneficiary of the ordinary income of the trust died on January 25, 1936. For all practical purposes the trust can be considered, during the year 1936, as administered for the charitable beneficiaries subject to the payment from ordinary income of the specific sums to the respective individuals named and subject to the specific payments directed to be made on the death of the life beneficiary. Respondent has in effect conceded this point, as there is no question but that the capital gains realized upon the sale of securi-

ties to secure funds to make the specific payments last referred to were permanently set aside for the charitable beneficiaries of the trust.

During the year 1936 petitioner paid from the principal of the trust estate the sum of \$18,533.86 to the executors of the estate of John Tonningsen. This sum was paid in settlement of a controversy regarding the liability of the trust estate for federal and state taxes arising on the death of John Tonningsen, who had died November 28, 1933. Petitioner paid this sum out of the principal of the trust estate and paid out the net ordinary income to the charitable beneficiaries. Petitioner contended and contends that the payments were properly made from the principal of the trust estate pursuant to the terms of the instrument creating the trust, and that respondent has erred in charging this sum back against income for tax purposes.

During the year 1936 petitioner paid out the sum of \$6000.00 from income for attorneys' fees; and credited the principal account of the trust and charged the income account with an additional \$1500.00 representing sums theretofore paid out of principal on account of attorneys' fees. Petitioner claimed the sum of \$7500.00 as a deduction on the return filed. A recent decision of the U. S. Supreme Court has indicated that this expense is not deductible under section 23(a) of the Revenue Act of 1936, as a business expense (*City Bank Farmers Trust Company v. Helvering*, Nos. 408 and 409, April 28, 1941, 85 L. ed. 788).

Nevertheless, petitioner contends that the sum represented thereby should not be included in the taxable

income for the year 1936, because the payment of these attorneys' fees constitutes a payment for charitable purposes and is deductible within the provisions of section 162(a) of the Revenue Act of 1936.

The two questions in regard to the year 1936 are presented here by petitioner's attack on the findings of fact and conclusions of law made by the Board (Tr. 22 to 25).

SPECIFICATION OF ERRORS.

1935.

Petitioner has attacked all of the findings of fact and conclusions of law which the Board particularly relied upon in denying the claimed deduction for 1935. These specifications may be conveniently summarized here as follows:

I.

The Board of Tax Appeals erred in its decision that there is a deficiency in petitioner's income tax for the year 1935. [Statement of Points, 1935, point I (Tr. 18); see Argument, 1935].

The first point of attack on this general conclusion is as follows:

II.

The Board of Tax Appeals erred in its decision that the capital gains realized in 1935 are not deductible under the provisions of section 162(a) of the Revenue Act of 1934 as income permanently

set aside or to be used for charitable purposes. [Statement of Points, 1935, points II A, III A, and IV A (Tr. 19-21); see Argument, 1935, point I].

It cannot be determined whether in reaching the conclusion last complained of the Board relied upon the payments made to the life beneficiary as in themselves defeating the authorized deduction, or as merely conclusively demonstrating that the gains pursuant to the terms of the trust were not set aside nor to be used as provided in the law. Consequently petitioner alleges as errors:

III.

The Board of Tax Appeals erred in its decision that the actual payments themselves defeated the charitable deduction, or that there was such a possibility of payments under the terms of the trust as would defeat the charitable deduction. [Statement of Points, points II B(1) and (2), II C(1), (1b) and (2), II D(1), (2) and (3), II B, II C, IV B(1) and (2), IV C and IV D (Tr. 19-22); see Argument, 1935, point I B].

As alternative grounds of error, if the conclusions of the Board are upheld from the facts petitioner alleges:

IV.

That the Board of Tax Appeals erred in including in petitioner's gross income capital gains to an extent greater than an amount actually

paid out by petitioner. [Statement of Points, points II A and IV A (Tr. 21); see Argument, 1935, point II].

V.

That the Board of Tax Appeals erred in including capital gains in the net income of petitioner when the income represented thereby, according to the Board's conclusions, was subject to control by the grantor of the trust. [Statement of Points, point I (Tr. 18); see Argument, 1935, point III].

1936.

Petitioner has similarly attacked all of the decisive conclusions of fact and law in reference to the year 1936. In view of the recent Supreme Court decision referred to above, petitioner no longer contends that the attorneys' fees paid from income in 1936 are deductible as a business expense, and the errors set forth in Statement of Points, 1936, points II B(1) and (2), III B, and IV B are consequently waived. The remaining alleged errors can be summarized as follows:

I.

The Board of Tax Appeals erred in including in the net taxable income of petitioner the amount paid from principal of the trust in compromise of a dispute with the executors of the estate of the first trustor, and in the attendant denial of a deduction of amounts paid from income to the

charitable beneficiaries. [Statement of Points, 1936, points I, II A(1), (2), (3) and (4), II C, III A(1), (2), (3) and (4), III C, IV A, and IV C (Tr. 22-25); see Argument, 1936, point I].

II.

The Board of Tax Appeals erred in denying the full deduction of the amounts paid to charities or on their behalf from income during 1936. [Statement of Points, 1936, points I, II C, III A(5), III C and IV C (Tr. 22-25); see Argument, 1936, point II].

ARGUMENT.

1935.

SUMMARY.

As pointed out above the Board of Tax Appeals made the payments disbursed from principal in 1935 the sole criteria of whether or not the gains realized in 1935 were permanently set aside or to be used exclusively for charitable purposes within the statutory deductions afforded by section 162(a) of the Revenue Act of 1934. Of course error in this regard would not be determinative if respondent's determination may be upheld on other grounds. Petitioner has therefore outlined below (Point I A) the decisions and principles applicable to the construction of section 162(a), and has further analyzed the facts, not only

to show that payments actually made did not defeat the deduction, but also that the provisions of the trust and the facts to which they must be applied demonstrate that petitioner was entitled to the deduction (Point I B).

If petitioner is in error as to its interpretation of the law and facts, the conclusions of the Board remain. It is submitted that these conclusions indicate, if actualities rather than provisions of the trust agreement are to govern this case, either (1) that all of the gains except a sum not in excess of \$3070.62 were actually set aside for the charitable beneficiaries (Point II), or (2) that all of the gains not so set aside were so subject to invasion by the life beneficiary of the trust that they were taxable to her as a grantor of the trust (Point III).

I.

THE CAPITAL GAINS REALIZED IN 1935 ARE DEDUCTIBLE UNDER THE PROVISIONS OF SECTION 162(a) OF THE REVENUE ACT OF 1934.

A. UNDER THE PROVISIONS OF SECTION 162(a) CAPITAL GAINS ARE PERMANENTLY SET ASIDE OR TO BE USED EXCLUSIVELY FOR CHARITABLE PURPOSES WHEN THE GAIN MEASURED THEREBY WILL ACCRUE TO CHARITABLE PURPOSES.

The income involved for the year 1935 is recognizable capital gains in the sum of \$32,785.40. Under the law of the State of California, in the absence of any contrary expressions of intent in the instrument creating the trust, these gains are to be regarded as

part of the corpus of the trust and are not available to the life beneficiary (*Estate of Gartenlaub*, 198 Cal. 204 at p. 213, 244 P. 348 at p. 351; *Estate of Canfield*, 104 Cal. App. 181, 285 P. 363, 28 Calif. Law. Rev., 34 at p. 54, November, 1939).

Section 162(a) of the Revenue Act of 1934 provides as follows:

“The net income of the estate of trust shall be computed in the same manner and on the same basis as in the case of an individual, except that—

“(a) There shall be allowed as a deduction (in lieu of the deduction for charitable, etc., contributions authorized by section 23(o)) any part of the gross income, without limitation, which pursuant to the terms of the will or deed creating the trust, is during the taxable year paid or permanently set aside for the purposes and in the manner specified in section 23(o) or is to be used exclusively for religious, charitable, scientific, literary, or educational purposes, or for the prevention of cruelty to children or animals, or for the establishment, acquisition, maintenance or operation of a public cemetery not operated for profit.”

In order to determine whether such gains are permanently set aside for or to be used exclusively for charitable purposes reference must be had to the provisions of the instrument creating the trust which refer to the disposition of corpus. The trust provisions must be considered in the light of the interpretation to be given the words “permanently” and “exclu-

sively" as used in the statute, and, in turn, some consideration must be given to interpretation of the phrase "set aside" as applied to income in the form of capital gains which by its nature is not the subject of specific identification.

Several possibilities suggest themselves:

In the first place, if the right to both income and principal of a trust are vested in charitable beneficiaries there could be no question but that accretions to the principal would be set aside for the benefit of the charitable beneficiaries.

Where there is an outstanding life interest to the income of a trust, with the remainder over to charitable beneficiaries, it could be argued that the accretions to principal were not permanently set aside, because of the possibility of frustration from economic reverses before the time of enjoyment. Reason and authority, however, demonstrate that in such a situation the income in the form of capital gains which becomes a part of the corpus of the trust ultimately to be received by charities, is deductible under the provisions of section 162a.

The Board of Tax Appeals has said:

"It seems clear to us that if the income [from the capital gain] should be reduced by the amount of the proposed tax, merely because certain beneficiaries are for life entitled to receive the income from the reinvestment thereof, the loss occasioned thereby would fall directly upon * * * the exempt corporation. It is our opinion, therefore, that the income in question is deductible under the pro-

visions of section 219(b) [Revenue Act of 1918] in determining the net income of the estate, for to hold otherwise 'would destroy the beneficent purpose of Congress'. *Lederer v. Stockton*, 260 U. S. 3".

Peoples Trust Co., Trustee, 10 B.T.A. 1385, 1393.

The Treasury Department recognizes a deduction in such circumstances (General Counsel's Memorandum No. 10423; Cumulative Bulletin XI-2, p. 127, December, 1932).

An examination of other cases dealing with the accumulation of income, either in the form of capital gains or ordinary income, by a fiduciary for ultimate distribution to charitable beneficiaries, reveals that mere delay in the time of enjoyment will not defeat the deduction.¹

When the corpus, of which the accumulated income becomes a part, pursuant to the terms of the instrument creating the trust, is subject to payments to other than charitable beneficiaries the battle flags are unfurled, and a wide field of controversy is disclosed. The Courts have looked to the intent of Congress and to several applicable analogies, in order to sustain the deduction when realities indicate that the income will ultimately be used for charitable purposes.

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1. *Slocum v. Bowers* (S.D., N.Y.), 15 F. (2d) 400;
Bowers v. Slocum (C.C.A. 2), 20 F. (2d) 350;
Beggs v. United States (Ct. Cl.), 27 Fed. Supp. 599, 607;
E. C. Johnson, Executor, 13 B. T. A. 850;
Hu L. McClung, et al., Executors, 13 B. T. A. 335;
Irving Bank-Columbia Trust Co., Executor, 8 B. T. A. 833;
Herbert Jermain Slocum, Executor, 6 B. T. A. 36;
Potter v. Bowers (C.C.A. 2), 89 Fed. (2d) 687;
E. Sohler Welch, et al., Trustees, 9 B. T. A. 1370.

The latest expression of the purpose of the adoption of the provisions of section 162a is that contained in *Commissioner v. Bonfils* (C.C.A. 10) 115 F. (2d) 788. The Court said:

“The purpose of Congress in enacting section 162 of the Revenue Act of 1934 was to encourage charitable gifts. Like provisions have been judicially construed so as to further and not hinder their beneficent purpose. *Lederer v. Stockton*, 260 U. S. 3, 8, 43 S. Ct., 5, 67 L. Ed. 99; *Old Colony Co. v. Commissioner*, 301 U. S. 379, 384, 57 S. Ct. 813, 81 L. Ed. 1169; *United States v. Provident Trust Co.*, 291 U. S. 272, 285, 54 S. Ct. 389, 78 L. Ed. 793. In *Lederer v. Stockton*, *supra*, the Supreme Court, in passing on whether income was received by a corporation operated exclusively for religious, charitable, scientific, or educational purposes, refused to adhere to the technical and formal provisions of a trust, saying, ‘To allow the technical formality of the trust, which does not prevent the Hospital from really enjoying the income, would be to defeat the beneficent purpose of Congress’. In *Old Colony Co. v. Commissioner*, *supra*, the Supreme Court refused to narrowly construe section 162 of the Revenue Act of 1928, 45 Stat. 838, 26 U. S. C. A., Int. Rev. Acts, page 405, which is substantially like section 162 of the Revenue Act of 1934, and held that income paid for charitable purposes was deductible, although it was not paid technically pursuant to the terms of the will, giving heed to actualities rather than the strict letter of the will. In *United States v. Provident Trust Co.*, 291 U. S. 272, 54 S. Ct. 389, 392, 78 L. Ed. 793, the court held that in determining the value of the devise

to charities, actualities rather than an arbitrary presumption should prevail.”

See, also:

Slocum v. Bowers (S.D., N.Y.) 15 F. (2d) 400;

Bowers v. Slocum (C.C.A. 2) 20 F. (2d) 350;

and cases cited in foregoing quotation.

In interpreting the statute and applying it to a given situation, a balance must be struck between the expressed intent of Congress to encourage charitable gifts, and the discouragement of any plan whereby a settlor may accumulate funds for non-charitable purposes through the guise of this charitable deduction (see: *Colt v. Duggan* (S.D., N.Y.), 25 F. Supp. 268, at p. 273).

The question of whether income which is accumulated as part of the corpus of a trust should be denied the charitable deduction (section 162(a)) because there are other payments which will or may be made out of the corpus, is analogous to the question of whether income periodically paid out by the trustee should be denied the deduction for distributions (section 162(b)) because the payments represented thereby might, in the event of insufficiency of income, be made a charge on the corpus of the trust. In criticism of the doctrine under the latter question whereby the income is taxed to the trust and not the beneficiary, it has been noted that the Courts have adopted a more realistic approach to the former question (see, *Union Trust Co. of Pittsburgh v. Commissioner* (C.C.A. 3), 115 F. (2d) 86, certiorari denied March 10, 1941, 85 L. Ed. 662 and Note 49 Yale Law Journal, 1496, p. 1498).

Another analogy is suggested by those decisions which deal with the provisions of the Federal Estate Tax statute which grant a deduction for the amount of all bequests, etc., for charitable purposes (see, Internal Revenue Code, section 812(d) and prior statutes). In *Ithaca Trust Co. v. United States*, 279 U. S. 151, 73 L. Ed. 647, the Supreme Court considered whether the fact that the support and maintenance of the life tenant was made a charge on the corpus of the trust would defeat the charitable deduction. The Court concluded that the standard of support fixed was capable of ascertainment and that since the income was apparently sufficient to maintain the life tenant under that standard "There was no uncertainty appreciably greater than the general uncertainty that attends human affairs."

See, also:

First National Bank v. Snead (C. C. A. 3), 24 F. (2d) 186;

Lucas v. Mercantile Trust Co. (C. C. A. 8), 43 F. (2d) 39;

Millard v. Humphrey (W.D., N.Y.), 8 F. Supp. 784 (aff'd. (C. C. A. 2), 79 F. (2d) 107).

The latest decision in regard to income taxes is that of *Commissioner v. Bonfils* (C.C.A. 10), 115 F. (2d) 788, wherein the charges against corpus were annuities in amount approximately one-fifth of the annual ordinary income of the trust. As in this case, the income in question was capital gains which became a part of the corpus of the trust. The Court referred to the intent of Congress, as quoted above, to the Federal

Estate Tax rule mentioned above, to *Hartford-Connecticut Trust Co. v. Eaton* (C.C.A. 2), 36 F. (2d) 710 (infra), and to the reenactment by Congress of provisions identical with those here in question after that decision, and concluded as follows:

“We, therefore, conclude that the question whether the corpus, including the capital gains, has been permanently set aside for charitable purposes should be determined by a consideration of the provisions of the will in the light of the actual facts respecting the amount of corpus set aside out of which annuities were to be paid, the income derived therefrom, the amount of annuities, and the degree of probability that corpus will be resorted to for annuity payments” (115 F. (2d) at p. 792).

The *Hartford-Connecticut Trust Co.* case (C.C.A. 2), 36 F. (2d) 710), referred to above had applied the doctrine of the *Ithaca Trust Co.* case to the field of income taxation and held that a provision for support out of corpus would not defeat a deduction of capital gains to be held for charitable remaindermen where it appeared it would never be necessary to rely on such provision.

See, also:

Hartford Connecticut Trust Co. v. Eaton (D. Conn.), 41 F. (2d) 69;

Hartford Nat'l Bank & Trust Co. v. Hartford Connecticut Trust Co. (D. Conn.), 20 A.F. T.R. 1325.

In view of the foregoing it would appear that if the income involved will actually reach the charitable

beneficiaries, the deduction is allowable, and will not be defeated because of a provision in the instrument creating the trust which theoretically permits recourse to a fund of which the income becomes a part, in the event income is insufficient. The cases relied upon clearly establish that the deduction is available if the fund, of which the income becomes a part, is wholly free from invasion as a practical matter.

Is the situation different when the fund is subject to invasion to an extent which is clearly determinable and which can in no event, exhaust it? Suppose, as in this case, the principal of the trust is subject to a life estate, and upon the termination thereof to the payment of sums aggregating less than one-seventh of its value to non-charitable beneficiaries, with the residue to charity. It can be argued that the portion of non-charitable purposes for which the fund may be used, as a portion of ink in a barrel of water, will color the whole, and that, therefore, any further addition to the whole will be stained with the same identification. [See dissenting opinion *Commissioner v. Bonfils*, 115 F. (2d) 788, 792.] On the other hand, it takes no lawyer, tax expert or judge, to appreciate that where the corpus as a whole increases in value, the benefit thereof accrues to the ultimate remaindermen, and not to the person or persons who have a fixed and determinable interest in the corpus. There is an indirect benefit to the latter, in that the security for their payment is enhanced, but the former are directly benefited, subject only to possible economic frustration, which, as phrased by Mr. Justice Holmes, is "no un-

certainly appreciably greater than the general uncertainty that attends human affairs”.

These factors have been recognized by the Courts.

In *Hartford Connecticut Trust Co. v. Eaton* (D. Conn.), 29 F. (2d) 840, the case giving rise to the appeal reported in 36 F. (2d) 710 and referred to above, the Court did not adopt the estate tax principles followed by the Circuit Court, but concluded as follows:

“If, therefore, under the terms of a will, income is payable to exempted beneficiaries, it may not be taxed, even though a power lodges in the trustee to divert it to nonexempt fields, because, under such circumstances, while it may become income to the personal beneficiary, nevertheless, until it actually accrues to him, it is not income to him. It therefore remains income ‘to be used’ for charitable purposes. Upon actual diversion, it may be taxable either as income of the trust or as income of the person to whom it was paid” (29 F. (2d) at p. 843).

In *Bowers v. Slocum* (C.C.A. 2), 20 F. (2d) 350, in upholding the charitable deduction in favor of an estate pending administration, where the residue was left to charities, the Court said:

“The purpose of the Congress to encourage bequests to corporations of the character of the residuary legatees is made plain by the deductions provided for by section 219, and the purpose of the act of 1918 was to insure the taxation of incomes which would eventually go to taxable persons in a more accurate and enforceable manner than was possible under prior laws, but not to tax

incomes which would go to corporations of the character of the residuary legatees. * * *

Section 219(b) does not make the deduction depend upon the action of the executors in crediting the income from their books, but upon the permanent setting aside of the income by the will itself for corporations of the character in question. The question, therefore, resolves itself into this: Was the income received by the estate during the year 1919 permanently set aside for the residuary legatees by the will itself? * * *

* * * the income in question, in the case at bar, reaches the beneficiaries of the bounty of the testatrix through the executors, and, if that income should be lost or reduced in amount, the loss occasioned thereby would be that of the residuary legatees, and therefore the income which the government is proposing to tax is the income of the residuary legatees" (20 F. (2d) at p. 352).

In the same case the District Court had said:

"I think it reasonable to suppose that the income on which income taxes must be paid by an executor while the estate is in process of administration or settlement is only such income as is ultimately taxable as such and that the liability of income to taxation does not depend on where the legal title is vested but upon who is ultimately entitled to the property constituting that income" (*Slocum v. Bowers* (S.D., N.Y.), 15 F. (2d) 400, at p. 404).

In *Lederer v. Stockton*, 260 U. S. 3, 67 L. Ed. 99, the charitable beneficiary actually received the income by virtue of a loan agreement with the trustee. It was

argued that the income was taxable to the trust. The Court, however, said:

“This residuary fund was vested in the hospital. The death of the annuitant would completely end the trust. For this reason, the trustee was able safely to make the arrangement by which the hospital has really received the benefit of the income, subject to the annuity. As the hospital is admitted to be a corporation whose income, when received, is exempted from taxation under section 11 (a), we see no reason why the exemption should not be given effect under the circumstances. To allow the technical formality of the trust, which does not prevent the hospital from really enjoying the income, would be to defeat the beneficent purpose of Congress” (260 U.S. at p. 8, 67 L. Ed. at p. 100).

Finally, it must be noted that the income in question here is a capital gain. From its nature it is not a specific article subject to definite identification. Since it arises on a sale or exchange it is impossible to determine what specific part of the proceeds of the sale or exchange represents return of invested capital and what specific part represents the gain or taxable income. It is, however, possible to measure the portion of the total value of the proceeds which represents the gain. It is this measurement which constitutes the taxable income and not the receipt of any specific property.

Conversely, it must follow that when the proceeds of sale or exchange from which a capital gain has been realized are “paid”, or “permanently set aside” or “to be used exclusively”, there is no specific property

involved which represents the gain or taxable income. In the case of a capital gain, Congress must have intended the phrase "any part of the gross income" to refer to the measurement of the gain.

Since the measurement of gain itself cannot be the subject of specific identification, it can only be said to be "paid", or "permanently set aside" or "used exclusively" to or for the person or persons whose interest is enhanced in value by an amount commensurate with the measured gain. In the case stated, and in this case, it would be the ultimate remainderman. Even though future economic fluctuations deprived the remainderman of the actual enjoyment of the amount of a capital gain realized in a particular prior year, it is permanently set aside to him and to be used exclusively for him in the prior year in the sense of a measurement of gain. It is one of the ebbs and flows in the tides of investment, sale and reinvestment which will determine the value of the remainder at any subsequent date. The transactions giving rise to the gain cannot be disregarded in tracing the ultimate value of the remainder. Consequently, so long as the amount of the gain will finally be available to the charitable beneficiaries under the practical administration of the trust, it should make no difference that a fixed portion of the corpus is appropriated for other purposes, which are unaffected by the gains.

It is, therefore, submitted that whether or not the capital gains for the year 1935 are deductible depends on whether or not the economic benefit represented thereby will ultimately be received by the charitable beneficiaries.

**B. THE FACTS DEMONSTRATE THAT THE CAPITAL GAINS
REALIZED IN 1935 ARE DEDUCTIBLE.**

At the beginning of the year 1935, John Tonningsen having died in 1933, the trust was irrevocable. The beneficial interest in the residue of the trust was vested in the charitable organizations. The interest of the charitable organizations was subject, during the life of Mrs. Tonningsen: (1) to the payment of the ordinary income to her during her lifetime (Article IV); (2) to the possibility that if she should be in need, the petitioner in its discretion might pay her such additional amounts out of principal as it might deem appropriate and necessary for her care, maintenance, support, or illness or other emergency (Article IV); and, after her death; (3) to the payment out of ordinary income, or out of principal, if necessary, of the costs, expenses and taxes mentioned in paragraph (a) of Article VII of the trust; (4) to the payment out of undistributed income, or out of principal, of the sum of \$104,000.00 to specific beneficiaries (Article VII, par. (b)); and (5) to the payment out of ordinary income of the sum of \$600.00 monthly to specific beneficiaries during their lives (Article VII, par. (b)) [Tr. 5, 27-30].

At the time of the death of John Tonningsen, respondent valued the assets of the trust at \$702,222.51. The trust estate was composed of real and personal property and yielded net income as follows:

1931	\$70,970.00
1932	73,984.18
1933	47,693.67
1934	45,571.58
1935 (11 months)	45,938.85

The petitioner's account for the year 1935 reveals that, from ordinary income of the trust, taxable and exempt, realized during that year, \$46,858.47 was paid to Pauline E. Tonningsen and \$2,417.99 was on hand at the end of the year, payable to her [Tr. 5 and 6].

Under the foregoing provisions and the facts applicable thereto, to whom did the economic benefit represented by the capital gains pass? Or, under a more strict interpretation of the statute for whose benefit was the corpus, of which the gains became a part, to be held?

(1) Neither the Actual Payments Made, Nor the Discretionary Provision of the Trust Defeat the Deduction.

The beneficiary received payments from sums constituting the corpus of the trust in 1934 and 1935. The statute provides that the charitable deduction applies to "any part of the gross income, without limitation, which *pursuant to the terms of the will or deed creating the trust*, is during the year paid or permanently set aside, etc." (italics added). Reference must be had to the terms of the trust to determine the ultimate disposition of the income in question; and conversely reference must be had to the terms of the trust to determine whether the amount so paid out, which it is contended defeat the charitable deduction, were paid out pursuant to such terms. The mere caprice of the trustee acting alone or in conjunction with others cannot affect the taxable incidents flowing from the directions contained in the trust instrument.

Freuler v. Helvering, 291 U.S. 35, 78 L. ed. 634;
Bowers v. Slocum (C.C.A. 2), 20 F. (2d) 350.

This principle was recognized by the Board in this case in deciding the issues for the year 1936, when it said:

“If, as respondent contends, the parts of the gross income in question were not, *pursuant to the deed creating the trust*, paid to the charities, the deduction would not be available.” [Tr. 39, italics added.]

Even the dissenting opinion in the *Bonfils* case [115 F. (2d) 788, 793] was predicated on this principle.

As demonstrated above, the situation involved is analogous to that arising in connection with the Federal Estate tax deduction for charitable beneficiaries.

In *Millard v. Humphrey* (W.C., N.Y.), 8 Fed. Supp. 784 (affirmed, C.C.A. 2, 79 F. (2d) 107), the Court concluded that the estate was entitled to a deduction under the Estate Tax, and said:

“There was no reasonable possibility of invasion of the principal at the time of Mr. Crosby’s death. The fact that an invasion did actually occur to the extent of \$6,900.00, by consent of the remaindermen, cannot affect the determination that at the time of decedent’s death the necessity of such an invasion was not foreseeable. Turning to the actual facts, merely for corroboration of this determination, it is found that Mrs. Crosby received as income from the estate a total of \$45,795.79, over a period of seventeen months, an average of over \$20,000.00 per year. Between the date of her husband’s death and her death, Mrs. Crosby’s estate increased over \$20,000.00. It is evident that the invasion was not necessary and

would not have been allowed over objection by the remaindermen'' (8 Fed. Supp. at p. 787).

No mention of this proposition is contained in the opinion of the Board of Tax Appeals, except in so far as it can be implied therefrom that the payments were predicated upon the discretionary clause of the trust. Petitioner has attacked the findings of fact and conclusions of law of the Board in so far as they touch on the foregoing points (Statement of Points, 1935, II C 1, II C 2, II D 1, II D 2, II D 3, III B, III C, IV B, IV C, and IV D, Tr. 18-22).

(a) There Is No Warrant For a Finding that the Payments Made Were Made "Pursuant to the Terms of the * * * Deed Creating the Trust".

In 1935 the life beneficiary was a paralyzed bed-ridden invalid of the age of 82 years, living in a hotel and maintaining herself and her niece. Her medical expenses for the period from January, 1934, to her death in January, 1936, averaged about \$62.00 per month. She had no servants other than the hotel afforded. The expenses of the services, rooms and meals furnished her and her niece for the period from November, 1933, to her death averaged less than \$750.00 per month. Her only other needs for care, maintenance, or support or because of her illness were her clothing and the constant attendance of one nurse [compare Findings of Fact, Tr. 30, and Statement of Facts, Tr. 6], the cost of which was not shown. By no stretch of the imagination could her needs approach or exceed the almost \$4000.00 per month which the income of the trust furnished her [Tr. 6].

It further appears that at the time of her death, shortly after the termination of the year in question, she left property of a value over \$190,000.00. During the years 1934 and 1935 she apparently accumulated over \$20,000.00 from payments made to her by the trustee [Tr. 7].

The Board made no findings as to the possible needs of the life beneficiary, but it is clear from the undisputed facts that the trustee would have no right to deem further sums necessary and appropriate for her care, maintenance, and support, or by reason of illness or other emergency, nor could she be said to be in need of a greater amount for such purposes. The income from the trust was over double the amount of her existent or possible needs for such purposes. The discretion conferred by the trust agreement is a legal discretion, and can only be exercised within the limits set forth. There are no applicable California decisions construing trust provisions analogous to those here in question. It has been determined that where a trustee is given discretion to make payments for support, maintenance, and education of a beneficiary it is no abuse of discretion for the trustee to refuse to make such payments when the beneficiary is receiving some support from other sources (*Estate of Smith*, 23 Cal. App. (2d) 393, 73 P. (2d) 239). It, therefore, appears that the trustee should, under California law, consider the beneficiary's other sources of support in determining whether additional payments are necessary. Under the general law of trusts, a beneficiary entitled to discretionary payments for support and maintenance is

only entitled to support and maintenance according to his "station in life".

California Civil Code, Section 2269;

Bogart, Trusts and Trustees, Vol. 4, p. 2351, sec. 812;

Hartford Conn. Trust Co. v. Eaton (C.C.A. 2), 36 F. (2d) 710;

Lucas v. Mercantile Trust Company (C.C.A. 8), 43 F. (2d) 39;

First National Bank v. Snead, (C.C.A. 3), 24 F. (2d) 186;

Millard v. Humphrey (W.D., N.Y.), 8 F. Supp. 784 (aff'd, C.C.A. 2, point conceded, 79 F. (2d) 107).

- (b) **The Evidence Shows that the Payments Were Made Out of the Funds of the Charitable Remaindermen and Not Pursuant to the Terms of the Trust.**

The payments made in 1934, the year prior to the year in question, were made after refusal by the trustee, and only after the consent of the charitable remaindermen was secured [Tr. 8]. In December 1934 the attorney for the life beneficiary addressed a request to the charitable beneficiaries that sums be paid from principal sufficient to make the total payments average \$5000.00 per month. In this request it was represented that the life tenant had voluntarily refrained from attacking the trust; that the income from the trust was something like \$2200.00 per month (in fact about \$3750.00 per month [Tr. 5]); that the life beneficiary was bedridden and trying to build up a fund for her relatives; that the bank refused to

make payments out of corpus without the consent of the remaindermen, and that she could not long survive [Tr. 8, 45 and 46]. Subsequently the charities consented to the payments requested and in 1935, the taxable year in question, \$9545.80 was paid out of the corpus of the trust to the life beneficiary [Tr. 8]. Although the consent of the charitable remaindermen referred to the discretionary provisions of the trust and to the demand made by the life beneficiary, there is no acknowledgment therein that she was in need, nor is there any reference to the exercise of its discretion by the trustee. In fact, the consent to the payments was gratuitously granted as a benefaction regardless of the needs of the life beneficiary [Tr. 8, 47-50].

That the trustee was justified in refusing the life beneficiary's demand is manifest from the facts concerning her circumstances previously outlined. That the charitable remaindermen were the real parties interested in the corpus of the fund is manifest not only from the provisions of the trust instrument itself, but from the conduct of the trustee and the life beneficiary who both recognized this apparent fact in predicated action upon their consent.

Consequently, such payments as were made, or that might have been made in the future, were not made "pursuant to the terms of the * * * deed creating the trust". They were made from funds which "pursuant to the terms of the * * * deed creating the trust" were "permanently set aside" or to be used exclusively for charitable purposes. The diversion was made by the

charities of their own funds, and cannot affect the taxable incidents of the income of the trust.

The Board disregarded the foregoing facts and rested its decision upon the fact that actual payments were made. There is, however, not a scintilla of evidence to justify a finding that the payments were or should have been made "pursuant to the terms of the * * * deed creating the trust", and its findings and conclusions must therefore be disregarded.

(c) Even If It Could Be Said that the Payments Were Made Pursuant to the Terms of the Trust, the Charitable Beneficiaries Would Not Be Deprived of the Benefit of the Capital Gains.

At the time the corpus of the trust was enhanced by the capital gains in question, it had a value sufficient to produce income in excess of \$49,000.00 and was appraised less than two years previously at a sum in excess of \$700,000.00. Of this sum, aside from such sums as the beneficiary might be entitled to under the discretionary clause, about \$100,000.00 was appropriated to specific bequests and miscellaneous charges were authorized for expenses, taxes, and the like [Tr. 5, 28-30]. The net residue which in the absence of invasion would pass to the charities can be taken at roughly \$600,000.00. The average payments from corpus to the life beneficiary, as revealed over a two year period, were slightly less than \$1200.00 per month [Tr. 8]. At this rate it would take over 40 years for the life beneficiary to exhaust the residue of the corpus. In other words, it has to be presumed that the invalid life beneficiary would live to an age in excess of 120 years before the residuary rights of the

charitable remaindermen would be defeated. If their rights to the residue would not be defeated certainly they, and they alone, would reap the benefit of any accretions to corpus. It is submitted that if the charitable remaindermen would secure this benefit, the recognizable gain by which it is measured is set aside and to be used exclusively for them even though the corpus as it existed, before and after the gain, was subject to invasion to an extent which could in no event consume it all.

(2) The Remaining Provisions of the Trust Do Not Defeat the Deduction.

In addition to the provisions of the discretionary clause, the corpus of the trust was also subject to the payment of costs, expenses, and taxes mentioned in Article VII(a) of the trust and to the payment of \$104,000.00 in specific bequests, all on the death of the life beneficiary [Tr. 28, 29]. These charges existed before and after the realization of the capital gains and could in no event be affected thereby. No possibility suggests itself whereby the payment of these charges would so invade corpus as to deprive the charitable remaindermen of the benefit of the capital gains. In fact the cases cited in the note under point I, A, *supra*, indicate that such a diversion of corpus will not defeat the deduction. Respondent in auditing petitioner's return for 1936 conceded that capital gains arising out of a sales to secure funds to pay these bequests and charges were deductible [Tr. 9].

The Board of Tax Appeals suggested that the provision for such payments would defeat the deduction,

and cited *Bank of America Nat'l Assn., Trustee*, 19 B.T.A. 1273 [Tr. 38]. In that case, however, the Board said:

“The facts are that in 1926 the amount of the principal of the trust was sufficient to provide a considerable sum for the next of kin and if we were to deal with probabilities it would be reasonable to say that the profits of \$27,874.81, and also future capital gains, would effect merely an increase in the amount left to the next of kin.” [19 B.T.A. at p. 1279].

So here it would be unreasonable to say that the capital gain of \$32,785.40 would effect an increase in the amount left to anyone other than the charitable remaindermen.

It is respectfully submitted that a consideration of the provisions of the trust involved together with the applicable facts and circumstances demonstrates that the capital gains realized in 1935 are deductible under the provisions of section 162(a) of the Revenue Act of 1934.

II.

'ALL CAPITAL GAINS EXCEPT POSSIBLY \$3070.62 WERE ACTUALLY RETAINED IN THE TRUST FOR THE CHARITABLE REMAINDERMEN.

The return and tax for the calendar year 1935 were due March 15, 1936 [Revenue Act of 1934, sections 53(a)1 and 56].

The life beneficiary died January 25, 1936 [Tr. 7]. Consequently at the time the tax was due all facts

concerning the actual invasion of the corpus of the trust, either pursuant to or contrary to the terms of the trust, were known and determined. The Board relies on the actual diversion of funds to sustain its conclusions. If the facts are examined it appears that in no sense were all of the capital gains diverted from charitable uses.

An analysis of the transactions giving rise to the capital gains and the amounts expended from corpus [Tr. 51 and 52] reveals that the last payment from corpus which was not by way of reinvestment or not compensated for by way of correction of error was made on August 31, 1935. For the few days of her life in 1936, the life beneficiary was paid \$5000.00 from income [Tr. 54]. Prior to and including August 31, 1935, there was paid to the life beneficiary \$9545.80, and \$100.00 in attorney's fees. The gross capital gains prior to that date were, however, but \$4241.95. Of this sum \$1171.33 of the \$2525.00 realized February 5, 1935, must have been necessary for and used for the investment made February 13, 1935, which leaves a balance of \$3070.62 possibly available for diversion. All of the rest of the capital gains were reinvested and so were actually set aside for the charitable remaindermen. The gross capital gains should be adjusted for that percentage which is not recognizable, and it can well be argued that the disbursements made should be prorated between gains and return of cost. Nevertheless, in the absence of other evidence, it is sufficient to say that petitioner by no stretch of the imagination should be taxed on more than \$3070.62.

In short, while petitioner does not acquiesce in the theory of the Board of Tax Appeals (see point I above), if the theory is to be applied, it should be applied with all of its logical implications. If actual diversion makes the gains, the benefit from which accrues to charitable purposes, taxable, the tax should extend no further than the total of the actual diversions, at least in a case like this where all possibility of further diversion has passed before the tax for the year in question is due.

III.

IF THE INCOME IS NOT HELD FOR THE CHARITABLE REMAINDERMEN IT IS TAXABLE TO THE GRANTOR-LIFE BENEFICIARY OF THE TRUST.

Petitioner contends that pursuant to the terms of the trust instrument the capital gains were set aside or to be used for charitable purposes so as to entitle it to a deduction. Respondent and the Board of Tax Appeals have taken the position that petitioner is not entitled to the deduction because the gains were subject to other uses, non-charitable in nature. If the gains were not set aside for the charities that very fact itself would relieve petitioner of the tax. The life beneficiary of the trust, in whose favor the discretionary clause was created, was also a grantor of the trust [Tr. 5, 27 and 28]. If income, in the form of capital gains, was paid to her, or accumulated for her benefit, rather than for the benefit of the charitable remaindermen, it should have been taxed to her and not to the trust.

A. IN SO FAR AS INCOME WAS REALIZED BY THE TRUST IN THE FORM OF CAPITAL GAINS AND PAID TO THE LIFE BENEFICIARY IT WAS DEDUCTIBLE UNDER SECTION 162(c) OF THE REVENUE ACT OF 1934.

Section 162 (c) of the Revenue Act of 1934 provides:

“* * * in the case of income which, in the discretion of the fiduciary, may be either distributed to the beneficiary or accumulated, there shall be allowed as an additional deduction in computing the net income of the estate or trust the amount of the income of the estate or trust for its taxable year which is properly paid or credited during such year to any * * * beneficiary.”

If, as contended by respondent, petitioner, in the exercise of its discretion, properly paid a portion of the capital gains realized in 1934 to the life beneficiary, the income represented thereby should be allowed as a deduction within the above section.

B. IN SO FAR AS INCOME WAS REALIZED BY THE TRUST IN THE FORM OF CAPITAL GAINS AND ACCUMULATED FOR THE GRANTOR-LIFE BENEFICIARY, IT WAS TAXABLE TO HER AND NOT TO THE TRUST.

In so far as income was realized by the trust in the form of capital gains and accumulated, it was either accumulated, and so was set aside, for the charitable beneficiaries as heretofore asserted, or was accumulated in a fund to be held for the benefit of the life beneficiary under the discretionary clause. In as much as the life beneficiary of the trust was a grantor of the trust the provisions of sections 166 and 167 of the Revenue Act of 1934 and the principle of *Helvering*

v. Clifford, 309 U.S. 331, 84 L.Ed. 788, become applicable.

Section 167 provides:

“(a) Where any part of the income of a trust—

“(1) is, or in the discretion of the grantor or of any person not having a substantial adverse interest in the disposition of such part of the income may be, held or accumulated for future distribution to the grantor; or

“(2) may, in the discretion of the grantor or of any person not having a substantial adverse interest in the disposition of such part of the income, be distributed to the grantor; or * * *

“(b) As used in this section, the term ‘in the discretion of the grantor’ means ‘in the discretion of the grantor, either alone or in conjunction with any person not having a substantial adverse interest in the disposition of the part of the income in question’.”

Rollins v. Helvering (C.C.A. 8) 92 F. (2d) 390 (certiorari denied 302 U.S. 763, 82 L. Ed. 592) involved taxation of capital gains accumulated in the trust. The commissioner contended they were taxable to the grantor. The trust provided:

“The trustee may from time to time apply to the use of myself, and my descendants, or any of us, so much of the principal of the trust as in its discretion it may deem advisable for our proper education, care, comfort and support.”

The grantor in that case also reserved the right to appoint himself trustee. The interest of the trustee,

even if not the grantor, is not, however, a substantial adverse interest in the disposition of the trust income or corpus (see *Reinecke v. Smith*, 289 U.S. 172, 77 L. Ed. 1109).

The grantor also had reserved a right to change the beneficial interests in the trust commencing at a time immediately on the termination of the taxable year in question. It was argued, as in this case, that the discretion given the fiduciary was subject to legal control and could not be exercised arbitrarily. The Court found that in view of the grantor's power to appoint himself trustee and the economic threat to any complaining beneficiary which was embodied in the grantor's reserved power to change such beneficiary's rights in the future, the grantor had the power to distribute the capital gains to himself during the taxable year.

The Court said:

“When every motive to normal human conduct convinces that a temporary legal right exists under such conditions that it would not be exercised, we cannot treat that right as an effective bar to a duty enjoined by law. We must be governed by actualities—particularly in tax matters. *Burnet v. Wells*, 289 U.S. 670, 678, 53 S.Ct. 761, 764, 77 L.Ed. 1439; *Reinecke v. Smith*, 289 U.S. 172, 177, 53 S.Ct. 570, 572, 77 L.Ed. 1109. We must hold that, in every real and practical sense, these instruments gave power to the petitioners to distribute or not distribute to themselves these capital gains in the tax year 1929. Having such power, they had a ‘discretion’ so to do within the meaning of section 167.”

The reasoning advanced parallels the contention made by the respondent and upheld by the Board here:

“Petitioners contend that since this invasion of corpus had the consent of the remaindermen, the charitable institutions, it is no proof that the life tenant was within her legal rights in demanding the payments from corpus. This may or may not be true, since the consent of the beneficiaries in despite of their financial interest might well proceed from a recognition on their part that a litigated contest would result unfavorably to them. But, be that as it may, our question is ‘a factual one’, *Helen G. Bonfils*, supra; not what were the legal rights of the parties but what were the actual probabilities. And if the consent of the remaindermen to the invasion of corpus was obtained in one year, there would be no reason to assume that it would not be forthcoming, as in fact it was, in the next.” [Tr. p. 38].

Consequently if the respondent and the Board are correct the conclusion reached in the *Rollins* case is determinative here, and the income was taxable to the grantor-life beneficiary and not petitioner.

See also:

Mary E. Wenger, 42 B.T.A. 225 (on appeal to C.C.A. 6);

Georgia B. Lonsdale, 42 B.T.A. 847.

Compare:

Katharine Boyd Morehead, 42 B.T.A. 851 (on appeal to C.C.A. 3);

Francis S. Willson, 44 B.T.A. No. 93 (May 27, 1941).

White v. Higgins (C.C.A. 1) 116 F. (2d) 312 was a suit for refund of taxes paid by the grantors of several trusts on income which they contended should be taxed to the trusts. Each trust consisted of life insurance on the life of the grantor's spouse and of securities, the income of which was to be used to pay premiums on the insurance. Each trust named the grantor and a corporate trust company as trustee, but contained provisions whereby the grantor could constitute himself sole trustee. Each trust was expressed to continue until three years after the death of its grantor's spouse, with accumulation of income not needed for premium payments in the interim. Each trust further provided:

“* * * if at any time during the continuance of this trust and during the lifetime of [the grantor's spouse] the Trustees shall deem it wise so to do they may use any of the funds in their hands specifically including the cash surrender value of said policy for the benefit of [the grantor and her issue] by paying out to her and them, or any one or more of them, such sums or sum out of the principal as they shall deem necessary or advisable for the comfort, maintenance, support, advancement, education or welfare of [the grantor] and said issue or any or more of them, or they may assign said policy and the trust property to said [grantor], in which case the trust shall cease and determine.”

More liberal provisions permitted the distribution of corpus during the three year period following the death of the grantor's spouse.

On a prior appeal (93 F. (2d) 357) the same Court had considered the taxability of the income to the grantors pursuant to sections 219 (g) and 219 (h) of the Revenue Acts of 1924 and 1926 (43 Stat. 277, 44 Stat. 34; the precursors of sections 166 and 167 referred to above). Its conclusions on the first appeal are recited in the second appeal as follows:

“We construed Article Third of the trust instrument, above quoted, as not conferring upon the trustees an absolute power to surrender the trust property to the grantor and thus terminate the trust, but rather as vesting in them a fiduciary power requiring a determination by the trustees that they deemed it necessary or advisable to use the principal for the comfort, maintenance, support, advancement, education and welfare of Clara C. Higgins or of any issue of her and John W. Higgins, or to surrender and assign the trust property to her. Since this was a power not vested in the grantor as grantor but only in herself as trustee, for so long as she remained a trustee, this court considered that the present was not a case ‘where the grantor * * * has * * * the power to revest [the corpus] in himself’, within the meaning of Section 219 (g). A similar conclusion was reached as to Section 219 (h).” [116 F. (2d) at p. 316].

This conclusion was allowed to stand under the doctrine of “law of the case”, but was disapproved by the Court then acting. The Court then considered the liability of the grantors under section 213(a) of the Revenue Acts of 1924 and 1926 (43 Stat. 267, 44 Stat. 23; the precursor of section 22(a) of the Revenue

Act of 1934), as interpreted by *Helvering v. Clifford*, 309 U.S. 331, 84 L. Ed. 788. The Court looked to the management power retained by the grantor, and the fact that she would ultimately benefit from the trust, and finally to her power under the discretionary clause of the trust, and concluded as follows:

“Under Article Third, if she as trustee should deem it advisable for her own ‘comfort, maintenance, support, advancement, education or welfare’, she is empowered to pay over to herself individually the whole or any part of the corpus. Granting that these are fiduciary powers, so were the powers of control over investment which the court regarded as significant in the Clifford case. With such a vague criterion of judgment prescribed in the trust instrument, it is highly improbable that anyone could successfully invoke the power of a court of equity to upset a decision by Mrs. Higgins as trustee to terminate the trust by assignment of the trust property to herself individually. It is equally improbable that any one of the ‘intimate family group’ would ever attempt to do so. In the Clifford case the court said (309 U.S. at page 335, 60 S. Ct. at page 557, 84 L.Ed. 788) that the grantor ‘has rather complete assurance that the trust will not effect any substantial change in his economic position. It is hard to imagine that respondent felt himself the poorer after this trust had been executed or, if he did, that it had any rational foundation in fact’. This quotation seems applicable to the cases at bar. If the emphasis is on economic realities, the reasons for taxing the income to the grantors in the present cases are at least as strong as in the Clifford case.” [116 F. (2d) at p. 320].

In this case the grantor-life beneficiary had no such powers of management, as the grantor in the *White* case. Nevertheless respondent contends and the Board found that the income herein in question was not set aside for the charitable beneficiaries because it would in all probability be used for the grantor-life beneficiary, and that the consent of the charitable beneficiaries would be forthcoming in the future. The Board looked to what it termed "actual events" and described the question as "a factual one" (Tr. 37, 38).

It is submitted that if these findings of the Board be sustained, the conclusion must be that there was no effective curb on the power of the grantor-life beneficiary to demand and secure payments from the corpus of the trust. In so far as she had such a power the income in the form of capital gains subject thereto should be taxed to her, and hence is not taxable to petitioner.

1936.

SUMMARY.

For the year 1936 the question involved is the inclusion in the net income of petitioner of amounts disbursed by it (1) out of principal, in compromise of an alleged liability for contribution on account of estate taxes assessed against the estate of the first trustor, and (2) out of income, for attorneys' fees for services in securing a reduction in said estate taxes. Respondent contends that the foregoing sums should have been

paid from income, and consequently disallowed a deduction of the sums actually paid by petitioner, from income, to the charitable beneficiaries.

As stated above, petitioner has withdrawn its claim that the amount of the attorneys' fees was deductible as a business expense. Herein petitioner contends: (1) that the amount paid by way of compromise was properly paid from principal (Point I); and (2) that all of the amounts disbursed are deductible as amounts paid for charitable purposes (Point II).

I.

THE AMOUNT PAID THE ESTATE OF JOHN TONNINGSEN WAS PROPERLY PAID FROM THE PRINCIPAL OF THE TRUST.

On June 30, 1936, petitioner paid \$18,533.86 to the executors of the Estate of John Tonningsen, and charged the same to the principal of the trust. During the same year petitioner paid the charitable beneficiaries \$17,178.44 and charged this amount to the income of the trust. Respondent contends that the former sum should have been paid from the income of the trust. He therefore reduced the deduction claimed by petitioner for income paid to the charitable remaindermen of the trust, on the ground such income was erroneously so paid, and included in the taxable income of petitioner the sum of \$13,496.63. This last sum being the proportion of the total paid to the executors represented by taxable as distinguished from exempt income [Tr. 12, 13, 53-56, Exhibit H].

The Board concluded that the sum paid was a payment of estate tax, that the trust deed required the payment of estate taxes out of income if the income in the year they are paid is sufficient therefor; and that the payments to the charitable remaindermen were not, therefore, pursuant to the terms of the trust [Tr. 39, 40].

Petitioner has attacked these findings in so far as they embody conclusions of fact and law or either, and the failure of the Board to find that petitioner properly accounted for the principal and income during the year in question [Statement of Points, 1936, II, A (1), (2), (3), (4), II C, III A (1), (2), (3), (4), III C, and IV; Tr. 22-25].

The facts disclose that the trust instrument provides as follows in regard to the administration of the trust after January 25, 1936, the date of the death of the life beneficiary [Tr. 5, 7, 28-30]:

“upon the death of the survivor of the Trustors, the Trustee shall administer the trust thereof in the manner following, to-wit:

“(a) Out of the income of the trust fund and estate, if that be sufficient, or out of the principal thereof, if necessary, the Trustee shall pay the costs and expenses of the surviving Trustor’s last illness and of his or her funeral and burial, unless other provision shall have been made therefor, and the inheritance tax upon all distributive shares of or interests in the trust fund and estate, if any be due, and any Federal Estate Tax due upon the whole thereof, and the costs and expenses of the Trust, including the compensation of the Trustee

and all preferred claims or charges against the trust estate, including interest thereon, and the Trustee, during the continuance of this Trust, shall, in its absolute discretion, devote such sums as it may deem necessary for the care and upkeep of the Pierre and Pauline Soms Vault in Holy Cross Cemetery, San Mateo County, California: said vault is presumably to be cared for under a contract providing for perpetual care thereof, but if, for any reason, said vault should not be properly cared for, the Trustee is urged to and authorized to make any necessary repairs thereto.

“(b) *Out of any undistributed income and/or principal of the trust fund and estate, the Trustee shall make the following payments: [A direction for payment of \$104,000 to specific individuals.]*

“(c) *Out of the net income of the trust fund and estate not required for any of the purposes aforesaid, the Trustee shall make the following payments: [A direction for payment of annuities aggregating \$600 per month.]*

“(d) *The Trustee shall pay over all of the net income of the trust fund and estate, not required for any of the purposes aforesaid, in perpetuity, as follows: [A direction is made for the payment of the income in equal shares to six organizations qualifying as charitable organizations under the applicable provisions of the Revenue Act.]”*
(Italics added.)

The facts in connection with the payment made are that it was made to the executors of the estate of the first trustor at a time almost three years after his death, by way of compromise of a dispute over the

liability of the trust for taxes arising by virtue of his death. The life beneficiary and surviving trustor died on January 25, 1936. It was not until June 12, 1936, that petitioner and the executors signed the agreement, pursuant to which the payment was made, in which it was recited as follows [Tr. 10-12, 57-60, Exhibit I]:

“* * * * *

“Whereas, prolonged controversy has existed between the parties hereto with respect to liability for the payment of the Federal estate tax due in the Estate of John Tonningsen, deceased; and

“Whereas, said parties desire a speedy and final determination of the Federal estate tax in the Estate of John Tonningsen, deceased, and with respect to the trust above referred, in accordance with the tentative determination above mentioned, and desire further to amicably adjust the controversy above referred in order to avoid the expense and uncertainty of delay and litigation;

* * * * *

“(3) It is expressly agreed and understood that this agreement is intended by way of compromise between the Trustee and the Executor of the controversy above referred to, is expressly limited thereto and shall not constitute, or be deemed, or be used in any proceedings as, an admission on the part of the Trustee of liability, nor preclude the Trustee from hereafter denying any liability, for payment, reimbursement, or contribution of any tax whatever under any circumstances, except liability for payment by way of compromise pursuant to and subject to the terms and conditions of this agreement.

* * * * *

“On the part of the Trustee this agreement is conditional upon and subject to assent thereof by the charitable beneficiaries of the trust, in writing, in terms satisfactory to the Trustee.”

Thereafter the charitable remaindermen consented to the agreement [Tr. 12, 60-61, Exhibit J].

It must be remembered that it is the intent of Congress to encourage charitable contributions [see 1935, point I A supra]. In *Old Colony Trust Co. v. Commissioner*, 301 U.S. 379, 81 L. Ed. 1169, one of the issues presented, and the conclusions thereon, are stated as follows:

“We are asked to hold that the words ‘pursuant to’ mean directed or definitely enjoined. And this notwithstanding the admission that Congress intended to encourage charitable contributions by relieving them from taxation. *Lederer v. Stockton*, 260 U.S. 3, 67 L. ed. 99, 43 S. Ct. 5; *United States v. Provident Trust Co.*, 291 U.S. 272, 285, 78 L. ed. 793, 979, 54 S. Ct. 389.

“‘Pursuant to’ is defined as ‘acting or done in consequence or in prosecution (of anything); hence, agreeable; conformable; following; according’.

“The words of the statute are plain and should be accorded their usual significance in the absence of some dominant reason to the contrary” [301 U.S. at p. 383, 81 L. Ed. at p. 1173].

The question therefore is whether the payment of income to the charities was “agreeable”, “conformable”, “following” or “according” to the terms of the trust instrument. Or, conversely, did the trust instru-

ment absolutely require the use of this income for other purposes. It is submitted not only that the Board's construction of the instrument is erroneous, but also that the Board erred in concluding that petitioner would not be entitled in the exercise of its discretion to pay this sum from principal.

A. PETITIONER WAS NOT REQUIRED TO MEET EXTRAORDINARY CHARGES OUT OF INCOME ACCRUING AFTER THE SURVIVING TRUSTOR'S DEATH.

The income to be paid to the charitable beneficiaries is "all of the net income of the trust fund and estate, *not required for any of the purposes aforesaid* [Article VII (d) italics added]. Going backward to determine the purposes aforesaid it appears that the trustors directed \$600 per month to be paid to annuitants "out of the net income of the trust fund and estate *not required for any of the purposes aforesaid*" [Article VII (c), italics added]. The charges prior to this clause are for the payment of \$104,000 to specific individuals "out of *any undistributed income and/or principal*" [Article VII (b), italics added]. \$100,000 net was so paid out by petitioner out of principal as augmented by the \$4992.22 income on hand at the date of the death of the life beneficiary, and no question has been raised in regard thereto.

It is the provisions for payment of the charges set forth in Article VII (a) which respondent contended and the Board found defeated the rights of the charities under Article VII (b). That section provides for payment "out of the income of the trust fund and estate, *if that be sufficient, or out of the principal*

thereof, if necessary” (italics added). The holding of the Board could not be questioned if the italicized words had been omitted. They were used by the trustors, however, and consequently must be given some effect. This factor was apparently in the Board’s mind when it said:

“The income of the trust for the year 1936 was sufficient to pay the estate taxes and attorneys fees in question. The trust deed requires that under those circumstances they be paid out of that income” [Tr. 40].

There is nothing in the trust deed which justifies the conclusion that the “sufficiency” of income or the “necessity” of resorting to principal to meet the charges mentioned in Article VII (a) is to be gauged by the amount of income realized in the calendar year 1936, or is to be gauged by the amount of income realized in the particular calendar year when the charge becomes payable, or for that matter, to be gauged by the amount of income realized in the particular calendar year when the trustee elected to pay the charge regardless of its due date. The determination of the “sufficiency” and “necessity” referred to above by such standards shows a preoccupation with the taxable incidents of income which, although a proper attribute of the reasoning of respondent and the Board, it would be unwarranted to attribute to the settlors of this trust. It is manifest that it was their intention to provide for the payment of the just charges against the trust estate, and to distribute the balance of the estate created, both income and principal, to the objects of their benefaction.

With this thought in mind it is apparent that the “sufficiency” of the income and the “necessity” of resorting to principal should be determined as of the date of the death of the surviving trustor. In the first place all of the payments to be made pursuant to the provisions of paragraphs (a), (b), (c) and (d) of Article VII relate back to one time—“the death of the survivor of the Trustors”. In the second place under the provisions of paragraph (c) the payments from income to specific annuitants are prefaced by the same condition as is in question in regard to the charitable beneficiaries—“out of the net income * * * not required for any of the purposes aforesaid”. Should petitioner have delayed the enjoyment of income by those beneficiaries for one year, or until sufficient income was realized to take care of all possible contingent charges? Under the law of the State of California a bequest of income passes the income from the date of death [California Probate Code, section 60]. The same principle should be applicable to a testamentary trust. It cannot be said that an interpretation which gives those entitled to income under paragraphs (c) and (d) that income from the date of the survivor is unreasonable, or unjustified in view of the discretion vested in the trustee to determine whether or not it is necessary to resort to principal for the payment of other charges. Moreover payment of extraordinary charges out of principal is expressly warranted by the law of the State of California. In *Estate of Kruce*, 10 Cal. App. (2d) 426, 51 P. (2d) 1174, the Court stated:

“The will provided for the payment of the net income to the daughter *after deducting all neces-*

sary taxes, costs and expenses, including the compensation of said trustees, the same to be paid in monthly instalments. It is appellants' contention that under this provision of the will the court was bound to charge the expenses in question to income. We do not agree that the will should be given this construction. It is not questioned that in the absence of contrary testamentary directions the ordinary and current expenses of a trust, including the trustees' compensation, should be paid out of income and that extraordinary and unusual charges should be paid from the corpus of the estate (In re Woods, 6 Cof. Prob. Dec. 451; Estate of Dare, 196 Cal. 29, 42 [235 Pac. 725]; Estate of Gartenlaub, 185 Cal. 648, 655 [198 Pac. 209, 16 A.L.R. 520]). We do not think the provisions of the will depart from this rule. The direction of the will would seem to apply to the current compensation and expenses of the trustees and not to anything of an extraordinary nature. The services for which the allowances were made consisted of closing the trust and distributing the property remaining therein after the death of the life tenant. They were performed necessarily for the benefit of the remaindermen and were unrelated to the management of the trust for the benefit of the life estate. They were not such ordinary and current expenses as would have to be deducted from the income periodically in order that the net income might be computed and paid to the life tenant each month as directed by the will [126 Cal. App. (2d) at p. 430, 51 P. (2d) at p. 1176, *italics added*].”

Finally if the words “not required for any of the purposes aforesaid” were to be given the rigid con-

struction indicated by the Board, with complete disregard of the other provisions of Article VII, it would follow that the enjoyment of the beneficiaries named in paragraphs (c) and (d) should be postponed to the payment of those mentioned in paragraph (b). The action of petitioner in paying these sums from principal pursuant to the words "out of any undistributed income and/or principal" has not been questioned. If petitioner had discretion to determine what is undistributed income under that clause, it certainly had discretion to determine the sufficiency of income and necessity for resort to principal under the provisions of paragraph (a).

B. THE PAYMENT MADE WAS NOT WITHIN THE SCOPE OF THOSE REFERRED TO IN ARTICLE VII(a).

Even if it be assumed that the trust should be construed so as to require petitioner to accumulate income to meet the charges specifically mentioned in paragraph (a), there is no warrant in extending the provisions of that paragraph to other extraordinary payments.

Paragraph (a) refers to "the inheritance tax upon all distributive shares of or interests in the trust fund and estate, if any be due, and any Federal Estate Tax due upon the whole thereof * * * and all preferred claims or charges against the trust estate, including interest thereon".

The payment in question was not made by virtue of any governmental demand for inheritance or estate taxes, nor was it made to any person or instrumentality

claiming a preferred claim or charge on the trust estate. The only liability for taxes involved was that asserted against the estate of the first trustor in the hands of his executors. The payment was made in compromise of an alleged claim for contribution made by said executors. It was not made pursuant to the trust, but with doubt of its propriety, and only with the consent of the charitable remaindermen.

Furthermore even if payment for such a purpose could be considered payment of a tax or a preferred claim, the provisions of the trust demonstrate that the only taxes or preferred claims referred to were those arising by virtue of the death of the survivor. If the first trustor died prior to his wife he wanted her to have the net income less only the costs and expenses of the trust estate [Article IV, Tr. 27]. Consequently taxes due from his estate were to be met therefrom. Article VII only deals with the administration of the trust "upon the death of the survivor of the Trustors". The construction of the trust instrument should not depend on the chance that the survivor should die before taxes against the first to die were settled. If this factor is eliminated it is clear that the taxes and charges mentioned in Article VII, paragraph (a) are those arising on the death of the survivor. Certainly the governmental agencies, or the executors of the estate of the first trustor, if they had a valid claim, could not be compelled to defer the collection thereof until the surviving trustor should die, and then until sufficient income was realized. Since the payment did not relate to taxes or charges arising on the death of

the surviving trustor, the provisions of paragraph (a) are inapplicable, and petitioner properly made payment out of principal in accordance with the general law cited above.

C. THE PAYMENT WAS NOT MADE PURSUANT TO THE TERMS OF THE TRUST, BUT ASIDE THEREFROM.

In connection with the issue for 1935 the Board of Tax Appeals stressed the fact that the charitable remaindermen had consented to payments from principal and thereby changed the nontaxable incident of income devoted to charities. As shown above those payments could in no sense be deemed pursuant to the terms of the trust.

In the present case there was also no express warrant for the payment involved. It was made, however, with the consent of the charitable remainderman. If, as referred to above, their action determines the taxable incidents of the payment made, their consent and acquiescence in the action taken by petitioner in connection with the payment to the executors should determine this issue. They authorized the payment, and after it was made received and retained the income which respondent contends should have been used therefor.

In short if actualities, over petitioner's objections, are to govern for the determination of the issue for the year 1935, they should equally control the issue herein discussed.

II.

THE PAYMENTS FOR ATTORNEYS' FEES AND TO THE EXECUTORS DO NOT REPRESENT TAXABLE INCOME, AS THEY ARE SUMS PAID FOR CHARITABLE PURPOSES.

At the time the attorneys' fees and the compromise payment were satisfied the trust was administered, with the exception of \$7200.00 a year from income, solely for the benefit of the charitable remaindermen. At the time of the threat of an increased liability of the estate of the first trustor for additional estate taxes, and the claim of the executors of his estate for contribution therefor, it was apparent that the loss, if any there was, would fall on the charitable remaindermen. The attorneys' services served to cut down the threatened tax liability, and the compromise payment, actually made with the consent of the charitable beneficiaries, served to protect and enhance the estate inuring to the benefit of the charitable purposes stressed by the trustors.

The attorneys' fees were paid from income, and it is urged by respondent that the compromise payment should have been so paid. If so paid were they not paid for charitable purposes? It is true that the mere fact that income is used to relieve corpus destined for charitable purposes of other charges will not make such income deductible [*Commissioner v. Bonfils* (C.C.A. 10) 115 F. (2d) 788 at p. 793]. In that case the income was used to pay annuities to other objects of the testator's bounty. Here, however, the income was not used to carry out private benefactions of the trustors, or, as might otherwise be the case, to pay the just obligations of the trustors, but solely for the

purpose of protecting and preserving a fund which is within the protection of the beneficent purpose of Congress. Certainly a charitable organization does not lose its immunity from direct income taxation because it uses its funds for such mundane purposes as hiring counsel to protect its property rights, or compromising asserted claims against it. So, here, income, which, though not paid directly to charitable organizations, is paid for their sole use and benefit should come within the statutory provisions [Section 162a of the Revenue Act of 1936].

CONCLUSION.

The fundamental issues for both years are practically the same. On the one hand the tax laws and the policy behind them, as enumerated by the Courts, have consistently scrutinized trust relationships in an effort to prevent resort to devices which would permit taxable income thereby devoted to private purposes from escaping its just contribution to the expenses of government. On the other hand, Congress and the Courts have just as consistently manifested the principle that income and property devoted to charitable purposes should enjoy immunity from such burdens.

In this case respondent and the Board of Tax Appeals have disregarded salient facts, and by judicious selection of particular facts, and particular provisions of the trust instrument propose to tax income the benefit of which inures solely to charitable purposes. For the year 1935 a small portion of the principal of

the trust was devoted to noncharitable purposes. Without deciding whether or not such diversion was justified under the provisions of the trust, the Board seized on this fact alone to justify the imposition of a tax on income which it was demonstrated both actually, and pursuant to the terms of the trust, inured for the benefit of charitable organizations. For the year 1936 the Board seized on one clause of a general section of the trust agreement, and overrode the practical interpretation thereof and the actual administration of the trust by petitioner as acquiesced in by the beneficiaries, in order to sustain a tax on income in part actually paid to charitable organizations, and unquestionably all paid or payable for charitable purposes.

It is respectfully submitted that the findings of fact and conclusions of law of the Board of Tax Appeals should be set aside, and reversed, and that an order be made here or below setting aside respondent's proposed determination.

Dated, San Francisco,
August 15, 1941.

J. W. RADIL,
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(Appendix Follows.)

Appendix.

Appendix

Revenue Act of 1934, section 22(a) :

“§ 22. Gross Income

(a) General Definition. ‘Gross income’ includes gains, profits, and income derived from salaries, wages, or compensation for personal service, of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. In the case of Presidents of the United States and judges of courts of the United States taking office after June 6, 1932, the compensation received as such shall be included in gross income; and all Acts fixing the compensation of such Presidents and judges are hereby amended accordingly.”

Revenue Act of 1934, section 23(o) :

“§ 23. Deductions from Gross Income

In computing net income there shall be allowed as deductions:

* * * * * *

(o) Charitable and Other Contributions. In the case of an individual, contributions or gifts made within the taxable year to or for the use of:

(1) the United States, any State, Territory, or any political subdivision thereof, or the District of Columbia, for exclusively public purposes;

(2) a corporation, or trust, or community chest, fund, or foundation, organized and operated exclusively for religious, charitable, scientific, literary, or educational purposes, or for the prevention of cruelty to children or animals, no part of the net earnings of which inures to the benefit of any private shareholder or individual, and no substantial part of the activities of which is carrying on propaganda, or otherwise attempting, to influence legislation;

(3) the special fund for vocation rehabilitation authorized by section 12 of the World War Veterans' Act, 1924;

(4) posts or organizations of war veterans, or auxiliary units or societies of any such posts or organizations, if such posts, organizations, units, or societies are organized in the United States or any of its possessions, and if no part of their net earnings inures to the benefit of any private shareholder or individual; or

(5) a fraternal society, order, or association, operating under the lodge system, but only if such contributions or gifts are to be used exclusively for religious, charitable, scientific, literary, or educational purposes, or for the prevention of cruelty to children or animals;

to an amount which in all the above cases combined does not exceed 15 per centum of the taxpayer's net income as computed without the benefit of this subsection. Such contributions or gifts shall be allowable as deductions only if verified under rules and regulations prescribed by the Commissioner, with the approval of the Secretary."

Revenue Act of 1934, section 162:

“§ 162. Net Income

The net income of the state or trust shall be computed in the same manner and on the same basis as in the case of an individual, except that—

(a) There shall be allowed as a deduction (in lieu of the deduction for charitable, etc., contributions authorized by section 23(o)) any part of the gross income, without limitation, which pursuant to the terms of the will or deed creating the trust, is during the taxable year paid or permanently set aside for the purposes and in the manner specified in section 23(o), or is to be used exclusively for religious, charitable, scientific, literary, or educational purposes, or for the prevention of cruelty to children or animals, or for the establishment, acquisition, maintenance or operation of a public cemetery not operated for profit;

(b) There shall be allowed as an additional deduction in computing the net income of the estate or trust the amount of the income of the estate or trust for its taxable year which is to be distributed currently by the fiduciary to the beneficiaries, and the amount of the income collected by a guardian of an infant which is to be held or distributed as the court may direct, but the amount so allowed as a deduction shall be included in computing the net income of the beneficiaries whether distributed to them or not. Any amount allowed as a deduction under this paragraph shall not be allowed as a deduction under subsection (c) of this section in the same or any succeeding taxable year;

(c) In the case of income received by estates of deceased persons during the period of ad-

ministration or settlement of the estate, and in the case of income which, in the discretion of the fiduciary, may be either distributed to the beneficiary or accumulated, there shall be allowed as an additional deduction in computing the net income of the estate or trust the amount of the income of the estate or trust for its taxable year, which is properly paid or credited during such year to any legatee, heir, or beneficiary, but the amount so allowed as a deduction shall be included in computing the net income of the legatee, heir, or beneficiary.”

Revenue Act of 1934, section 167:

“§ 167. Income for Benefit of Grantor

(a) Where any part of the income of a trust—

(1) is, or in the discretion of the grantor or of any person not having a substantial adverse interest in the disposition of such part of the income may be, held or accumulated for future distribution to the grantor; or

(2) may, in the discretion of the grantor or of any person not having a substantial adverse interest in the disposition of such part of the income, be distributed to the grantor; or

(3) is, or in the discretion of the grantor or of any person not having a substantial adverse interest in the disposition of such part of the income may be, applied to the payment of premiums upon policies of insurance on the life of the grantor (except policies of insurance irrevocably payable for the purpose and in the manner specified in section 23(o), relating to the so-called ‘charitable contribution’ deduction);

then such part of the income of the trust shall be included in computing the net income of the grantor.

(b) As used in this section, the term ‘in the discretion of the grantor’ means ‘in the discretion of the grantor, either alone or in conjunction with any person not having a substantial adverse interest in the disposition of the part of the income in question’.”

Revenue Act of 1936, sections 23(o) and 162:

[Same text as Revenue Act of 1934, above].

No. 9837

**In the United States Circuit Court of Appeals
for the Ninth Circuit**

BANK OF AMERICA NATIONAL TRUST AND SAVINGS ASSO-
CIATION, TRUSTEE OF THE JOHN AND PAULINE TON-
NINGSSEN TRUST, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

ON PETITION FOR REVIEW OF THE DECISION OF THE UNITED
STATES BOARD OF TAX APPEALS

BRIEF FOR THE RESPONDENT

SAMUEL O. CLARK, Jr.,
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FILED

SEP 25 1941

PAUL P. O'BRIEN

CLERK

INDEX

	Page
Opinion below.....	1
Jurisdiction.....	1
Questions presented.....	2
Statutes involved.....	2
Statement.....	2
Summary of argument.....	8
Argument:	
I. (a) The claimed deduction does not come within the scope of Section 162 (a)	11
(b) Neither Section 167 nor Section 162 (c) authorizes the claimed deduction.....	26
II. (a) The payments made to charities in 1936 were not made from income, and if they were made from income they were not so made pursuant to the terms of the trust..	29
(b) The payment of a fee to an attorney is not a payment to charity within the meaning of Section 162 (a) of the Revenue Act of 1936.....	32
Conclusion.....	32
Appendix.....	33

CITATIONS

Cases:

<i>Boston Safe Deposit & T. Co. v. Commissioner</i> , 66 F. (2d) 179, certiorari denied, 290 U. S. 700.....	11
<i>Bowers v. Slocum</i> , 20 F. (2d) 350, affirming 15 F. (2d) 400.....	24
<i>Buhl v. Kavanagh</i> , 118 F. (2d) 315.....	27, 28
<i>Chambers v. Commissioner</i> , 33 B. T. A. 1125.....	29
<i>City Bank Farmers' Trust Co. v. United States</i> , 74 F. (2d) 692...	13
<i>Commissioner v. F. G. Bonfils Trust</i> , 115 F. (2d) 788.....	13
<i>First Nat. Bank v. Snead</i> , 24 F. (2d) 186.....	24
<i>Gammons v. Hassett</i> , 121 F. (2d) 229.....	15
<i>Guaranty Trust Co. of New York v. Commissioner</i> , 31 B. T. A. 19, affirmed per curiam, 76 F. (2d) 1010, certiorari denied, 296 U. S. 591.....	17
<i>Hartford-Connecticut Trust Co. v. Eaton</i> , 36 F. (2d) 710.....	19
<i>Hartford-Connecticut Trust Co. v. Eaton</i> , 41 F. (2d) 69.....	20
<i>Hartford Nat. B. & T. Co. v. Hartford-Connecticut T. Co.</i> , decided September 17, 1937.....	20
<i>Helvering v. Butterworth</i> , 290 U. S. 365.....	13
<i>Helvering v. Kehoe</i> , 309 U. S. 277.....	19
<i>Helvering v. Northwest Steel Mills</i> , 311 U. S. 46.....	13
<i>Helvering v. Pardee</i> , 290 U. S. 370.....	29

Cases—Continued.

	Page
<i>Humes v. United States</i> , 276 U. S. 487.....	15
<i>Ithaca Trust Co. v. United States</i> , 279 U. S. 151.....	14, 22
<i>Lauriston Inv. Co. v. Commissioner</i> , 89 F. (2d) 327.....	19
<i>Lucas v. Mercantile Trust Co.</i> , 43 F. (2d) 39.....	24
<i>Millard v. Humphrey</i> , 8 F. Supp. 784.....	24
<i>Moorman Home for Women v. United States</i> , 42 F. (2d) 257.....	11
<i>New Colonial Co. v. Helvering</i> , 292 U. S. 435.....	13
<i>Old Colony Trust Co. v. Commissioner</i> , 38 B. T. A. 828.....	29
<i>Pennsylvania Co. for Insurances, Etc. v. Brown</i> , 6 F. Supp. 582, affirmed <i>per curiam</i> , 70 F. (2d) 269.....	11
<i>Sparkman v. Commissioner</i> , 112 F. (2d) 774.....	13
<i>Smith, Estate of</i> , 23 Cal. App. (2d) 383.....	23
<i>Weigel v. Commissioner</i> , 96 F. (2d) 387.....	29
<i>Welch v. Helvering</i> , 290 U. S. 111.....	18

Statutes:

Revenue Act of 1934, c. 277, 48 Stat. 680:	
Sec. 22 (U. S. C., Title 26, Sec. 22).....	29
Sec. 162 (U. S. C., Title 26, Sec. 162).....	33
Sec. 167 (U. S. C., Title 26, Sec. 167).....	34
Sec. 275 (U. S. C., Title 26, Sec. 275).....	34
Revenue Act of 1936, c. 690, 49 Stat. 1648, Sec. 162.....	35

Miscellaneous:

4 Bogart, Trusts and Trustees, Sec. 812.....	22
Restatement, Trusts, Sec. 128, Comment e.....	23
Rules of the Circuit Court of Appeals for the Ninth Circuit, Rule 19 (6).....	26
1 Scott on Trusts, Sec. 128.4.....	23

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v.

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*ON PETITION FOR REVIEW OF THE DECISION OF THE UNITED
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BRIEF FOR THE RESPONDENT

OPINION BELOW

The only previous opinion in this case is the opinion of the United States Board of Tax Appeals (R. 25-43) reported in 43 B. T. A. 37.

JURISDICTION

This case involves income taxes for the years 1935 and 1936. The decision of the Board of Tax Appeals was entered on January 31, 1941. (R. 44.) Petition for review was filed on April 26, 1941. (R. 15-18.)

The jurisdiction of this Court rests upon Sections 1141-1142 of the Internal Revenue Code.

QUESTIONS PRESENTED

1. (a) Whether the taxpayer may take as a deduction the amount of capital gains realized in 1935 as income permanently set aside for charitable purposes within the meaning of Section 162 (a) of the Revenue Act of 1934.

(b) Whether the taxpayer may take the amount of these capital gains as a deduction under Section 167 or Section 162 (c) of the Revenue Act of 1934.

2. (a) Whether certain payments made by the taxpayer to charities in 1936 were made from income of the trust, and if made from income, whether they were so made pursuant to the terms of the trust.

(b) Whether the taxpayer may take a deduction of the amount of an attorney's fee as income paid to charity within the meaning of Section 162 (a) of the Revenue Act of 1936.

STATUTES INVOLVED

The statutes involved are set out in the Appendix, *infra*, pp. 33-35.

STATEMENT

I

The facts are taken from the findings of fact by the Board of Tax Appeals and the agreed statement of the proceedings on review. They are as follows:

The taxpayer is the trustee of the John and Pauline Tonningsen Trust created August 7, 1930. (R. 27.)

The trust names John Tonningsen as the first trustor and Pauline E. Tonningsen, his wife, as the second trustor. (R. 27.) Under the terms of the trust the net income was payable to the first trustor during his lifetime. (R. 27.) At his death the trust was to become irrevocable and the net income was to be paid to the second trustor. (R. 28.) The trust instrument provided (R. 28) that if the second trustor were—

in need of a greater amount than said net income for her care, maintenance and support, or by reason of illness or other emergency, the Trustee may, in its absolute discretion, pay to her, out of the principal of the trust fund and estate, such additional amounts as it may deem necessary and appropriate for the purposes aforesaid, and no one, howsoever interested in the Trust, shall be competent to object thereto.

On the death of the survivor of John and Pauline Tonningsen the trustee was directed to pay (R. 28-29):

(a) Out of the income of the trust fund and estate, if that be sufficient, or out of the principal thereof, if necessary, * * * the costs and expenses of the surviving Trustor's last illness and of his or her funeral and burial, unless other provision shall have been made therefor, and the inheritance tax upon all distributive shares of or interests in the trust fund and estate, if any be due, and any Federal Estate Tax due upon the whole thereof, and the costs and expenses of the Trust, * * *.

(b) Specific gifts to individuals amounting to \$104-000 which were made a charge upon both the undistributed income and the principal of the trust fund;

(c) annuities aggregating \$600 per month (R. 29-30); (d) all of the net income not required for any of the foregoing purposes was to be paid to six organizations qualifying as charitable organizations under the applicable provisions of the revenue act (R. 30).

At the time of John Tonningsen's death on November 28, 1933, the taxpayer valued the assets of the trust at \$702,222.51. (R. 30.) At the time of her husband's death Pauline Tonningsen was 81 years old. She was paralyzed and confined to her bed and wheel chair. This condition continued until the time of her own death on January 25, 1936. (R. 30-31.) During this period she lived in a hotel with her niece, Louise Weyer. (R. 30.) The hotel books showed expenses incurred by her for November and December of 1933 of \$1,338.98; for 1934, \$8,210.22; for 1935, \$8,744.05; for January, 1936, \$723.91. (R. 31.) During the years 1934, 1935 and 1936, her bills for physicians' services totaled \$635, \$796 and \$122, respectively. (R. 31.)

After the death of John Tonningsen all of the income of the trust was paid to Pauline Tonningsen. (R. 31.) Beginning with February, 1934, the trustee paid Pauline Tonningsen \$5,000 per month without regard to the income received by the trust. The charities which were the remaindermen of the trust had given their consent to this arrangement when the trustee had objected to making these payments unless it was held harmless by the remaindermen. The charities consented to the same arrangement in December of 1934, and again on April 3, 1935, the latter consent being for a period of one

year from March 1, 1935, or less in the event of Pauline Tonningsen's prior death. (R. 31.) The payment of this monthly sum to Pauline Tonningsen required the invasion of the corpus in 1934 to the extent of \$16,614.53, and in 1935, to the extent of \$9,545.80. (R. 31.)

All payments made to Pauline E. Tonningsen were deposited in her commercial account at the Bank of America. The balance in this account was \$36,615.78 on January 2, 1935, and \$36,088 on December 31, 1935. Over objection that the evidence was immaterial and irrelevant, the taxpayer was permitted to show that Pauline E. Tonningsen opened a savings account with the same institution on January 5, 1934, with a deposit of \$228.15; that by virtue of deposits aggregating \$19,047.26 and interest credits of \$334.32, the balance in the account on December 31, 1934, was \$19,609.73; that during the year 1935, there was deposited in this account the sum of \$5,390.27 in amounts and on dates which corresponded with withdrawals from the aforementioned commercial account; that no withdrawals were made from this savings account during the life of Pauline E. Tonningsen, and that the balance therein, on December 31, 1935, including interest credits of \$523.97 in 1935, which was unchanged at the time of the death of Pauline E. Tonningsen, was \$25,523.97. (R. 7-8.)

At the time of her death Pauline Tonningsen had an individual estate subsequently appraised at \$87,046.67 and bank accounts in joint tenancy with Louise Weyer in the sum of \$103,067.06. (R. 31-32.)

The trust estate was composed of real and personal property and yielded net income as follows (R. 32):

1931-----	\$70,970.00
1932-----	73,984.18
1933-----	47,693.67
1934-----	45,571.58
1935-----	¹ 45,938.85

¹ According to the agreed statement of proceedings on review this income was for eleven months of the year 1935. (R. 5.)

During the year 1935, the taxpayer realized in addition to other income the sum of \$32,785.40 as taxable income from capital gains. (R. 32.) The taxpayer claimed a deduction for the amount of these capital gains under the terms of Section 162 (a) of the Revenue Act of 1934. The deduction was disallowed by the Commissioner as not coming within the terms of Section 162 (a) and a deficiency was assessed accordingly. The Board of Tax Appeals sustained the Commissioner's determination. The Board found as a fact that during the year 1935 it was probable that these capital gains would be invaded for non-charitable purposes. (R. 37-38.)

II

During the year 1936, the taxpayer realized gross taxable income of \$74,989.57. (R. 32.) At the time of Pauline Tonningsen's death on January 25, 1936, there was a balance in the income account of the trust of \$4,922.22 which amount was transferred to the principal account on that date. (R. 9.)

A deficiency in estate tax had been proposed against the executors of the estate of John Tonningsen by virtue of the assets in the trust. (R. 10, 33.) The execu-

tors made claim upon the taxpayer for the payment of this deficiency. The taxpayer denied liability on the ground that the payments specified in Article VII (a) of the trust were to be made upon the death of the survivor of the trustors and no payments could be made for those purposes while Pauline Tonningsen was still alive. (R. 33.) A similar issue arose with respect to the California estate tax. (R. 33.) The taxpayer realized it might be liable so it employed counsel and sought to be recognized by the Commissioner as a taxpayer in those proceedings. (R. 33.) Over the objection of the taxpayer the Commissioner was permitted to introduce in evidence a letter from the taxpayer's attorney in which he stated, in appealing to the Commissioner to permit the taxpayer to be represented at the proceedings, that the taxpayer was willing to pay a share of the tax. (R. 11.) The efforts of the taxpayer resulted in a reduction of the proposed deficiency in the estate tax upon the estate of John Tonningsen. (R. 11.) On June 12, 1936, which was after Pauline Tonningsen's death, the executor of the estate of John Tonningsen and the taxpayer reached an agreement relative to the amount of federal and California estate taxes which the taxpayer would pay. (R. 33-34.) Under this agreement the taxpayer paid the executors of the estate of John Tonningsen \$18,533.86. (R. 34.) The taxpayer charged this amount to principal on its records. (R. 34.) In July and December of 1936, the taxpayer paid to charities designated in the trust instrument a total of \$17,178.44,

charging these amounts against income on its records. (R. 34.)

The taxpayer took a deduction for the amount paid to charities in 1936 on the ground that these amounts were income paid to charities within the meaning of Section 162 (a). The Commissioner disallowed the claimed deduction on the ground that the amounts paid to charities were in reality paid not from income but from corpus and were therefore not deductible. The Commissioner's determination was sustained by the Board.

On November 16, 1935, the taxpayer had paid the attorney representing it in connection with the federal estate tax proposed deficiency, \$500, and had charged the same to the principal account of the trust. On July 9, 1936, \$500 was credited to the principal account and charged against the income account of the trust, and an additional \$1,000 was paid to the attorney. Subsequently, on July 22, 1936, an additional \$6,000 was paid to the attorney and charged to the income account. (R. 12-13.)

The taxpayer took a deduction for the attorney's fee in its return for 1936 as a business expense. The Commissioner disallowed the claimed deduction, and was sustained by the Board.

SUMMARY OF ARGUMENT

I

A deduction is not permissible under Section 162 (a) if under the terms of the will or deed of trust there is

any possibility that the income may be used for purposes other than charitable. Not only is this the plain meaning of the words of Section 162 (a), which allows a deduction only of amounts *permanently set aside* for charity, but policy considerations require that the statute be so construed. If the deduction be allowed even though there is a possibility that the income will be diverted to non-charitable purposes, there would be no opportunity to tax the income later if it were diverted, and the congressional intent to tax all income would be frustrated. Furthermore, deductions depend upon legislative grace, provisions granting them must be strictly construed, and a taxpayer must come squarely within the terms of a section permitting a deduction to be entitled thereto. Application of this test to the facts herein requires the denial of the deduction, since the capital gains here involved were subject to many possibilities of diversion from charitable uses.

Although some cases have held that if there is a practical certainty that the income will be used for charitable purposes Section 162 (a) is satisfied, this rule defeats rather than aids the congressional purpose to encourage charitable contributions, for the rule stimulates the hedging of charitable gifts with conditions. But even if this test be applied to the instant case the taxpayer cannot succeed. The question of the probabilities of diversion of the income to non-charitable purposes is one of fact. The Commissioner's determination is presumptively correct; and the Board of Tax Appeals having resolved the fact issue against the tax-

payer, its finding must be sustained if there is substantial evidence in the record in support thereof. The evidence fully supports the Board's conclusion. Comparison of the facts herein with the facts in the cases relied upon by the taxpayer reveals such a great difference in degree that the taxpayer can derive no support from those cases.

The arguments based on Sections 167 and 162 (c) are not open to the taxpayer since they are not within the statement of points intended to be relied upon on appeal. Moreover there is no merit to the arguments based on those sections. Section 167 is not applicable because there is no proof that Pauline Tonningsen was the grantor of this trust. On the contrary the evidence indicates that John Tonningsen was the grantor. Section 162 (c) does not apply where, as here, the capital gains become part of the corpus under state law.

II

The claimed deduction for 1936 is not allowable if the terms of the trust indenture directed the payment of taxes from income. The terms of the trust are explicit on this point, leaving small room for construction. They expressly direct the payment of taxes from income, if sufficient. Since the income was sufficient to meet this payment, the claimed deduction is not allowable.

The payment of a fee to an attorney is not a payment to charity and is therefore not deductible under Section 162 (a).

ARGUMENT

I

(a) The claimed deduction does not come within the scope of Section 162 (a)

Section 162 (a) of the Revenue Act of 1934 authorizes the deduction from gross income by trust estates of the amount—

which pursuant to the terms of the will or deed creating the trust, is during the taxable year paid or permanently set aside for the purposes and in the manner specified in section 23 (o), or is to be used exclusively for religious, charitable, scientific, literary, or educational purposes, or for the prevention of cruelty to children or animals, or for the establishment, acquisition, maintenance or operation of a public cemetery not operated for profit;

* * * *

We agree with the taxpayer that the statute makes the deduction depend upon the terms of the deed creating the trust. In order for the taxpayer to be entitled to the benefit of this section it must demonstrate that the capital gains in question were “paid or permanently set aside” for charitable purposes *pursuant to* the terms of the trust indenture.

The courts have adopted two tests in resolving the question whether income accruing to a trust estate is deductible under the terms of this section. We submit that the proper test is that enunciated in *Boston Safe Deposit & T. Co. v. Commissioner*, 66 F. (2d) 179 (C. C. A. 1st), certiorari denied, 290 U. S. 700, and *Charles P. Moorman Home for Women v. United States*, 42 F. (2d) 257 (W. D. Ky.). See also *Pennsyl-*

vania Co. for Insurances, Etc. v. Brown, 6 F. Supp. 582 (E. D. Pa.), affirmed *per curiam*, 70 F. (2d) 269 (C. C. A. 3d). The test laid down by these cases is as follows: If under the terms of the will or deed of trust there is any possibility that the income may be used for purposes other than charitable, then the deduction is not allowable. This is the only construction which gives full meaning and content to the words of Section 162 (a). It will be noted that the statute requires that the income be either paid or permanently set aside for charitable purposes. The words "permanently set aside" must be construed in the light of the use of the word "paid", and it would therefore seem that Congress intended that before the deduction could be taken there be an absolute certainty that the money would be used for charitable purposes. Further strength is given to this construction by the use of the word "exclusively" in the remaining portion of this section. Unless the test be the one adopted in the foregoing cases the words "permanently set aside" and "exclusively" are delimited to the point where they are deprived of their proper meaning.

Policy considerations also dictate that this is the only reasonable construction to give to the statute. The income from the trust estate must be taxed in the year in which it is realized or never. Once the deduction is allowed, there is no opportunity to tax the income if it is diverted; it was for this reason that Congress required definite assurance that income be irrevocably dedicated to charitable purposes before it be relieved from the burden of tax. Congress wished to encourage chari-

table contributions and provided for a deduction from gross income in aid of that purpose. But this purpose is subsidiary to the general all-pervading purpose of the revenue act to tax all income. *Helvering v. Butterworth*, 290 U. S. 365. In allowing the deduction for income to be used for charitable purposes Congress chose the words used in order to render certain that no deduction would be taken unless it was absolutely certain that the money would go for those purposes. When there is added to these considerations the rule that deductions depend upon legislative grace, provisions granting them must be strictly construed, and a taxpayer must come squarely within the terms of a section permitting a deduction to be entitled thereto [*New Colonial Co. v. Helvering*, 292 U. S. 435; *Helvering v. Northwest Steel Mills*, 311 U. S. 46; *Sparkman v. Commissioner*, 112 F. (2d) 774 (C. C. A. 9th)], we submit that the deduction permitted by Section 162 (a) is not available if there is any possibility of diversion to non-charitable purposes.

There are, however, decisions to the effect that if the possibility of the use of the fund for non-charitable purposes is so remote that it may be said that there is a practical certainty that the funds will be devoted to the charitable purpose, the deduction is permissible. *Commissioner v. F. G. Bonfils Trust*, 115 F. (2d) 788 (C. C. A. 10th);² *Hartford-Connecticut Trust Co. v. Eaton*, 36 F. (2d) 710 (C. C. A. 2d); see also *City Bank Farmers' Trust Co. v. United States*, 74 F. (2d) 692 (C. C. A. 2d). This test is applied upon the theory that

² Note the strong dissent by Judge Bratton.

since the purpose of Congress was to encourage charitable contributions the section should be construed liberally. We submit, however, that this construction defeats rather than aids the congressional purpose. A decision which allows the deduction from gross income of gains accruing to a trust despite the fact that those gains are subject to invasion for non-charitable purposes, will encourage testators and grantors to hedge charitable gifts with conditions. Far greater aid would be rendered to the congressional purpose by a decision that a deduction is not allowable unless there are no conditions attached to the dedication of the money to charitable purposes. Once strings are allowed to be attached to a charitable gift without defeating the right to a deduction under Section 162 (a), impetus is given to the creation of trusts having such strings attached. Certainly in many cases the occasion will arise when the conditions will come into full force and effect and thereby defeat the ultimate gift to charity.

The decisions applying the probability test rely upon *Ithaca Trust Co. v. United States*, 279 U. S. 151. That case involved Section 403 (a) (3) of the Revenue Act of 1918, which permitted the deduction from the gross estate subject to estate tax of the amount of gifts to charities. In that case the testator gave the residue of his estate to charities subject to a life estate in his wife with authority to invade the corpus to the extent "that may be necessary to suitably maintain her in as much comfort as she now enjoys." The Supreme Court held that the language of the will had placed a limit upon the possible invasion of the corpus

which was capable of definite measurement in terms of money and therefore the residuary gifts to charity could be computed and deducted from the value of the gross estate. It is to be noted that that case arose under a statute which allowed a deduction of the *amount* of a gift to charity. The only problem presented was whether the value of the residuary bequest could be determined at all. Cf. *Humes v. United States*, 276 U. S. 487. But the question here is not simply one of attempting to place a value on the charitable gift, but whether the income was *permanently set aside* for charitable purposes. The *Ithaca Trust Co.* case does not authorize courts to speculate. Moreover, the narrowly and definitely limited possibility of corpus diversion for non-charitable purposes in the *Ithaca Trust Co.* case is not here present.

The limits of the application of the *Ithaca Trust Co.* case are demonstrated by the recent decision in *Gammons v. Hassett*, 121 F. (2d) 229 (C. C. A. 1st). That case involved the same issue which was presented in the *Ithaca Trust Co.* case, namely, the deductibility of a residuary bequest to charity from the gross estate under the estate tax. There the decedent bequeathed the residue of his estate to named charities subject to a direction (p. 230) that the income and "so much of the principal thereof as my said wife may at any time and from time to time need or desire, * * * be paid to my said wife during her life." At the time of the death of the decedent his wife was 93 years old and had been bedridden for more than

of the home, and that meantime the value of the assets had increased, it cannot be foretold whether that situation will always obtain. There is always the possibility that, because of economic changes or unsuccessful management, the income will diminish, with the result that the annuities will have to be paid in whole or in part from the corpus, as they were during the period immediately following the testator's death, and the residuary estate for charitable uses thus reduced. Clearly, until by complete discharge of all the annuities upon death of the several beneficiaries the estate is freed from the charge laid upon it for their payment, no amount certain, either of corpus or income, can be said to be definitely and permanently set aside exclusively for charitable uses. * * *

If this test be applied to this case it is obvious that the taxpayer is not entitled to the claimed deduction. Any one of the various conditions attached to the gift to charity in this case would be sufficient to defeat the right to a deduction.

However, even if the question be viewed as one of probabilities the taxpayer cannot succeed. The case upon which the taxpayer relies most heavily, *Commissioner v. F. G. Bonfils Trust, supra*, holds that this question is one of fact. The Commissioner's determination was adverse to the taxpayer and his determination is presumptively correct. *Welch v. Helvering*, 290 U. S. 111, 115. In addition the Board has found as a fact that the actual probabilities were that the capital gains here in question would be invaded for non-charitable purposes and its decision must be sustained by this Court

if there is substantial evidence to support it. *Helvering v. Kehoe*, 309 U. S. 277; *Lauriston Inv. Co. v. Commissioner*, 89 F. (2d) 327 (C. C. A. 9th).

The use of the probability test in the construction of the statute makes the question primarily one of degree. A comparison of the facts in this case with the facts in the cases which have applied the probability test reveals such a great difference in degree that no support is lent to the taxpayer's position by those cases.

In the *F. G. Bonfils Trust* case, *supra*, the issue, as in this case, was whether capital gains were permanently set aside for charitable purposes within the meaning of Section 162 (a). There the corpus of the estate was approximately \$8,000,000, of which almost one-half was invested in Government and municipal bonds. The current income was approximately one-half million dollars and the average annual income for five years had been about that figure. The only possibility of corpus invasion was to make good annuities approximating \$100,000 a year. Of the ten annuitants, two had already died, one was past 80, three were past 70 and two were past 60. The majority of the court said that it was certain that there would be a decrease in the amount of annuity payments in the near future, and reached the conclusion that the evidence established beyond a reasonable doubt that there would never be any recourse to the corpus to pay the annuities.

In *Hartford-Connecticut Trust Co. v. Eaton*, 36 F. (2d) 710 (C. C. A. 2d), the income from an estate

of \$1,000,000 was to go to the decedent's wife and the trustee had the power to invade the principal to support her according to her station in life. The case came up on a demurrer to a complaint which alleged that the widow lived in a "modest way"; that she had an income of her own; and that "her character, taste," and "standard of living" were such "that there was at no time any reasonable possibility that the plaintiff as trustee would deem it necessary or advisable to use any part of the trust fund for her comfortable maintenance and support." Essentially the same situation was presented in *Hartford-Connecticut Trust Co. v. Eaton*, 41 F. (2d) 69 (Conn.), which also arose on a demurrer. In that case the only possibility of corpus invasion was to meet a \$5,000 annuity, but the corpus was over a million dollars and had produced income for a six-year period of from \$70,000 to \$120,000 annually. In *Hartford Nat. B. & T. Co. v. Hartford-Connecticut T. Co.* (Conn.), decided September 17, 1937, not officially reported but may be found in 20 A. F. T. R. 1325, the annuity which was made a charge on the corpus was only \$6,000, whereas the estate had a value of \$1,700,000, had grown to this size in fifty years from \$342,000, and was producing income in excess of \$80,000 per year. The court found as a fact that there was no chance of corpus invasion.

The facts in the case *sub judice* are not at all comparable to the facts in any of these cases. In the first place, the net income of the trust here suffered a serious decline from 1931 to 1935. There is no record

here of extremely successful management of the trust estate as there was in *Hartford Nat. B. & T. Co. v. Hartford-Connecticut T. Co.*, *supra*. Secondly, it is to be noted that in the *F. G. Bonfils Trust* case the court deemed it of great importance that approximately half of the \$8,000,000 corpus was invested in governmental obligations. According to Exhibit H (R. 53), the 1936 income of this estate (aside from capital gains) was derived exclusively from rentals, except for a small amount derived from dividends. In comparison with governmental obligations rentals are extremely hazardous from the standpoint of yield. Thirdly, in each of the other cases there was only one condition attached to the ultimate disposition of the corpus to the charities. In this case the interest of the charitable organizations was subject to many prior charges: (a) the possibility of invasion of corpus in order to provide for the care, maintenance, support, illness or other emergencies of Mrs. Tonningsen; (b) the payment of the various costs, expenses and taxes enumerated in Article VII (a) of the trust, which were made a charge upon the principal; (c) the payment of the sum of \$104,000 to specific individuals which was also a charge upon the corpus; and (d) the payment of annuities amounting to \$7,200 per year.

The effect of these prior charges must be measured with respect to the situation as it existed in 1935. The statute requires that the amounts sought to be deducted be permanently set aside for the designated purposes *during the taxable year*. Anything occurring after the taxable year could not affect the ques-

tion whether the amounts were so set aside during the prior year. Therefore the death of Mrs. Tonningsen early in 1936 is without significance upon this question. See *Ithaca Trust Co. v. United States*, 279 U. S. 151.

The taxpayer has stated that by no stretch of the imagination could Mrs. Tonningsen's needs exceed the approximate \$4,000 which the income of the trust furnished her, relying upon the evidence of her hotel bills and medical expenses. But there is no evidence in the record to show that these were the *only* expenses which she had. There are no facts to show for what other purposes Pauline Tonningsen spent money, or that she was a frugal woman. The taxpayer's assertion that she apparently accumulated over \$20,000 *from payments made to her by the trustee*, is pure conjecture. There is no evidence showing *all* of Mrs. Tonningsen's receipts and disbursements. The very fact that she demanded more than the net income from the trust is evidence to show that her needs were in excess of that income. Moreover by the terms of the trust the corpus was subject to invasion to provide for illness or other emergencies befalling Mrs. Tonningsen. Who could have said in 1935 that her illness would not later require large sums or that some other emergency might not arise?

No significance attaches to the fact that Mrs. Tonningsen had a separate estate, for the general rule is as follows (4 Bogart, Trusts and Trustees, Sec. 812, p. 2352):

If the trust is for the purpose of supporting the life beneficiary, and the trustee is given dis-

cretion as to the amount necessary, he may pay from the trust funds whatever is needed for such support, even though the cestui has other income. The intent of the settlor is not that the trust shall supplement existing income of the cestui, but he has expressed a wish to furnish all the income needed for support. * * *

and in Restatement, Trusts, Sec. 128, Comment e, p. 327:

It is a question of interpretation whether the beneficiary is entitled to support out of the trust fund even though he has other resources. The inference is that he is so entitled. * * *

See also 1 Scott on Trusts, Sec. 128.4.

Estate of Smith, 23 Cal. App. (2d) 383, 73 P. (2d) 239, is not to the contrary. It merely holds that a court will not interfere with the exercise of discretion by a trustee unless it is abused. With respect to the question presented here, *power* in the trustee to invade the corpus for the benefit of Mrs. Tonningsen without regard to her other resources is the controlling consideration.

With regard to the annuities it is to be noted that there is no evidence in the record concerning the ages of the annuitants or their life expectancies. During the taxable year in question the corpus was invaded for non-charitable purposes to the extent of \$9,545.80, and in the preceding year to the extent of \$16,614.53. As the Board said, the actual facts demonstrated that substantial amounts were taken from the corpus in each year. Of course as the corpus was depleted the income would drop, thus necessitating increasingly

drastic invasions of the corpus. Furthermore at the death of Pauline Tonningsen the trustee was required to distribute a large portion of the estate to specific beneficiaries and to pay various costs, expenses and taxes. The application of a substantial part of the corpus to these purposes would leave a seriously depleted estate to bear the charges of the annuities.

We submit that upon these facts the petitioner is placing the responsibility of omniscience upon this Court in attempting to obtain a ruling that the income from this trust will be sufficient for an indeterminate number of years to meet the cost of these annuities even after the estate has been seriously depleted by the various other prior charges. We think it is apparent from the comparison of the facts in this case with the facts in the cases relied upon most heavily by the taxpayer that there is no parallel between his authorities and his case. Little need be said about the other cases cited by the taxpayer on this point. In *First Nat. Bank v. Snead*, 24 F. (2d) 186 (C. C. A. 5th), which involved the deduction allowable under the federal estate tax, the case also arose on a demurrer and the facts were comparable to the *Ithaca Trust Co.* case. *Lucas v. Mercantile Trust Co.*, 43 F. (2d) 39 (C. C. A. 8th), and *Millard v. Humphrey*, 8 F. Supp. 784 (W. D. N. Y.), also involved the issue in, and presented facts parallel to, the *Ithaca Trust Co.* case. *Bowers v. Slocum*, 20 F. (2d) 350 (C. C. A. 2d), affirming 15 F. (2d) 400, (S. D. N. Y.), merely decided that when income is irrevocably dedicated to charitable corporations by the terms of a will it is unnecessary that

it be paid or credited to the beneficiaries by the trustee in the taxable year in order to be deductible.

The taxpayer argues that the payments were not made pursuant to the terms of the trust but were made out of the funds of the charitable remaindermen. The fact that the trustee refused to make any payments from corpus without the consent of the remaindermen, is, of course, no evidence that Pauline Tonningsen had no right to payments from corpus. The trustee merely acted with prudence in order to protect itself. The contention that the payments were not made pursuant to the terms of the trust but were made from the funds of the charitable remaindermen requires the surprising conclusion that the charities either misappropriated their funds or else had power to use their funds to benefit private wealthy individuals. If the charities did have such power then the deduction would not be allowable under the express terms of Section 23 (o).

The argument that the average payments from the corpus to the life beneficiary would have had to continue for forty years in order to exhaust the residue of the corpus obviously misses the point. In the first place, each invasion of the corpus would result in a corresponding reduction of the income thereby requiring greater invasions in the following year. The invasions would progress geometrically, not arithmetically. Secondly, the taxpayer attempts to show that each one of the conditions attached to the dedication of this trust fund to charities would not of itself defeat the ultimate enjoyment of the fund by the chari-

ties but, of course, the case can not be so broken down. It is necessary to determine whether the combined effect of all the conditions makes it impossible to say that there was a practical certainty that the capital gains here in issue would ultimately go to the charities.

(b) Neither Section 167 nor Section 162 (c) authorizes the claimed deduction

The taxpayer has raised for the first time in its brief the contentions that if the capital gains were not deductible under Section 162 (a) of the Revenue Act of 1934, they were deductible under Sections 167 and 162 (c). We submit that these contentions are not available to the taxpayer at this stage of the case. The statement of points to be relied upon on appeal is long and detailed and, aside from the general allegation that the Board of Tax Appeals erred in deciding that there was a deficiency, none of the points raises the questions here sought to be litigated. Rule 19 (6) of this Court states in mandatory language that this Court will consider only those points which have been stated as points on which the appellant intends to rely. This objection has more than technical merit. Since the statute of limitations now bars any additional assessment against Pauline Tomningsen (Sec. 275, Revenue Act of 1934), it would be most unfair to permit the taxpayer at this time to contend that this income was not its income at all—a position diametrically opposed to its prior position.

If the Court should come to consider the taxpayer's contentions with respect to Sections 167 and 162 (c)

on the merits, then we submit that there is no validity to the taxpayer's arguments. With respect to Section 167, it is only necessary to point out that that section applies only where income may be accumulated for the benefit of the *grantor*. It was and is therefore requisite for the taxpayer to demonstrate that Pauline Tonningsen was the grantor of this trust. As was said in *Buhl v. Kavanagh*, 118 F. (2d) 315, 320 (C. C. A. 6th):

The word "grantor" is not defined in the statutes, and therefore is to be given its natural, ordinary and familiar meaning. *DeGanay v. Lederer*, 250 U. S. 376, 381, 39 S. Ct. 524, 63 L. Ed. 1042. Putting the word in its ordinary setting, it means the person who establishes the trust or its donor, creator or founder. An express trust must be an explicit declaration of trust, accompanied by an intention to create such an estate and followed by an actual conveyance or transfer of definite property, or estate or interest made by a person capable of such a transfer and for a definite term, which vests the legal title in a person capable of holding as trustee for the benefit of a *cestui que* trust or purpose, to which the trust fund is to be applied or the retention of title by the owner under circumstances which clearly and unequivocally disclose intent to hold for use of another. Obviously a person who has no title or interest in property can create no trust therein. *Brainard v. Commissioner*, 7 Cir., 91 F. 2d 880. * * *

There is no evidence in the record to sustain such a conclusion. Whatever evidence there is on this point tends to the conclusion that John Tonningsen was the grantor. The fact that the trust speaks of John Tonningsen as

first trustor and Pauline Tonningsen as second trustor is immaterial. Those words may have been used simply as a means of designating particular persons by the draftsman of the instrument. In *Buhl v. Kavanagh*, *supra*, the court did not consider it important that a particular person was named as grantor.³ The fact that the value of the trust was taxed to the estate of John Tonningsen under the estate tax indicates that he was the grantor. Moreover the taxpayer's consistent contention that the income here involved was income of the trustee and deductible under Section 162 (a) involves a representation that Pauline Tonningsen was not the grantor of the trust. The only other reference to this question which may be gleaned from the record is the letter of John L. McNab, an attorney, to the San Francisco Unit of the American Red Cross (Ex. E, R. 45). The first two paragraphs of this letter read as follows:

I recall to your attention the fact that John Tonningsen before his death established a trust of about half a million dollars with the Bank of America for six beneficiaries, of which you are one.

In reality this was not John Tonningsen's property. It was the property of his wife. She was inclined to attack the trust and had she done so would probably have been successful. She was persuaded not to engage in litigation.

Of course, this letter is hearsay and does not establish the fact that Pauline Tonningsen was, in fact, the

³ *Buhl v. Kavanagh*, 118 F. (2d) 315, 321:

It is true that in the form in which the present transaction was consummated, appellant was referred to as the grantor of the trust. This does not preclude the inference that her father was in fact the grantor. * * *

grantor of this trust. If the letter be considered at all it merely indicates that there is a great deal of doubt about who was, in fact, the grantor of the trust. Since the taxpayer is relying on Section 167, the doubt must be resolved against it.

The argument based on Section 162 (c) must also fail. The rule is well settled that capital gains which become part of the corpus under state law are not deductible by the trustee under this section even though the trustee in the exercise of the power to distribute corpus actually distributes the capital gains. *Helvering v. Pardee*, 290 U. S. 370; *Weigel v. Commissioner*, 96 F. (2d) 387 (C. C. A. 7th); *Chambers v. Commissioner*, 33 B. T. A. 1125; *Old Colony Trust Co. v. Commissioner*, 38 B. T. A. 828. The reason for the rule is fundamental. Although such capital gains are taxable income within the meaning of the Revenue Act, distributions of corpus are not taxable to the distributee according to Section 22 (b) (3). If the trustee were allowed a deduction under the terms of Section 162 (c) in these circumstances, then the income would escape taxation altogether.

II

(a) The payments made to charities in 1936 were not made from income, and if they were made from income they were not so made pursuant to the terms of the trust

The deduction allowed by Section 162 (a) is not allowable unless the amounts paid to charities are so paid pursuant to the terms of the trust. We contend that the amounts paid by the taxpayer to the charities, which the taxpayer designated in its accounts as

paid from income, were not payable from income according to the terms of the trust. As the Board stated (R. 39):

The issue, therefore, narrows to the question whether the trust instrument provided that the payments of estate taxes and attorneys' fees should be made from income or whether it directed that the income should be used for the payments to charity.

Of course, the action of the trustees in crediting the various payments in 1936 to the principal and income accounts is not determinative.

The terms of Article VII (a) of the indenture are so clear that there is, as the Board said, "small room for construction". The instrument provides that the taxes, costs and expenses be paid "out of the income of the trust fund and estate, if that be sufficient, or out of the principal thereof, if necessary, * * *." (R. 40.) Since at the time these payments were made income was available to meet them, the trustee was required to meet the charges from income. The suggestion that the sufficiency of the income to meet the charges of Article VII (a) should be determined as of the date of the death of Pauline Tonningsen is without merit, for this would render the direction to pay these charges from income meaningless since all of the income up to the date of Pauline Tonningsen's death was payable to her. The taxpayer makes point of the fact that the payment in question "was not made by virtue of any governmental demand for inheritance or estate taxes, nor was it made to any person or instru-

mentality claiming a preferred claim or charge on the trust estate.” (Br. 54–55.) Aside from the questionable accuracy of this statement in view of the fact that the trustee sought to be recognized as a taxpayer in the John Tonningsen estate tax proceedings, the point is obviously immaterial. Article VII (a) of the indenture requires the payment of estate taxes *due* upon the trust fund and estate. It is not limited to the payment of estate taxes upon which the trustee *was liable*.

The argument that the taxes mentioned in Article VII (a) are those arising on the death of the survivor of John and Pauline Tonningsen has no basis in the terms of the trust instrument. The taxes which the trustee was directed to pay were the “inheritance tax upon all distributive shares of or interests in the trust fund and estate, if any be due, and *any* Federal Estate tax due upon the whole thereof.” (Italics ours; R. 29.) Of course, the governmental agencies would not be required to defer collection of taxes with respect to this trust estate until the death of the survivor of John and Pauline Tonningsen, but there is no reason why the executors of the estate of the decedent whose estate was charged with these taxes could not be required to wait until the death of the survivor in order to secure reimbursement from the trustees. The trust instrument so provided and the trustees took that very position when the executors of the estate of John Tonningsen demanded payment before Pauline Tonningsen had died.

(b) The payment of a fee to an attorney is not a payment to charity within the meaning of section 162 (a) of the Revenue Act of 1936

Little need be said with respect to the claimed deduction of the attorney's fee. The deduction was first claimed as a business expense but that contention has been abandoned. The deduction is now claimed on the basis of Section 162 (a). We point out that this contention is not covered by the statement of points intended to be relied upon on appeal. But quite aside from this point, Section 162 (a) allows the deduction only of amounts paid to charities. Certainly the attorney who received this fee did not receive it as charity. The statute does *not* provide that the expenses of a trust estate which pays part of its income to charity may be deducted.

CONCLUSION

The decision of the Board of Tax Appeals is correct and should be affirmed.

Respectfully submitted.

SAMUEL O. CLARK, JR.,
Assistant Attorney General.

GERALD L. WALLACE,

BERNARD CHERTCOFF,
Special Assistants to the Attorney General.

SEPTEMBER, 1941.

APPENDIX

STATUTES INVOLVED

Revenue Act of 1934, c. 277, 48 Stat. 680:

SEC. 162. NET INCOME.

The net income of the estate or trust shall be computed in the same manner and on the same basis as in the case of an individual, except that—

(a) There shall be allowed as a deduction (in lieu of the deduction for charitable, etc., contributions authorized by section 23 (o)) any part of the gross income, without limitation, which pursuant to the terms of the will or deed creating the trust, is during the taxable year paid or permanently set aside for the purposes and in the manner specified in section 23 (o), or is to be used exclusively for religious, charitable, scientific, literary, or educational purposes, or for the prevention of cruelty to children or animals, or for the establishment, acquisition, maintenance or operation of a public cemetery not operated for profit;

* * * * *

(c) In the case of income received by estates of deceased persons during the period of administration or settlement of the estate, and in the case of income which, in the discretion of the fiduciary, may be either distributed to the beneficiary or accumulated, there shall be allowed as an additional deduction in computing the net income of the estate or trust the amount of the income of the estate or trust for its taxable year, which is properly paid or credited during such year to any legatee, heir, or beneficiary, but the amount so allowed as a deduc-

tion shall be included in computing the net income of the legatee, heir, or beneficiary.
(U. S. C., Title 26, Sec. 162.)

SEC. 167. INCOME FOR BENEFIT OF GRANTOR.

(a) Where any part of the income of a trust—

(1) is, or in the discretion of the grantor or of any person not having a substantial adverse interest in the disposition of such part of the income may be, held or accumulated for future distribution to the grantor; or

(2) may, in the discretion of the grantor or of any person not having a substantial adverse interest in the disposition of such part of the income, be distributed to the grantor; or

(3) is, or in the discretion of the grantor or of any person not having a substantial adverse interest in the disposition of such part of the income may be, applied to the payment of premiums upon policies of insurance on the life of the grantor (except policies of insurance irrevocably payable for the purposes and in the manner specified in section 23 (o), relating to the so-called “charitable contribution” deduction);

then such part of the income of the trust shall be included in computing the net income of the grantor.

(b) As used in this section, the term “in the discretion of the grantor” means “in the discretion of the grantor, either alone or in conjunction with any person not having a substantial adverse interest in the disposition of the part of the income in question”.

(U. S. C., Title 26, Sec. 167.)

SEC. 275. PERIOD OF LIMITATION UPON ASSESSMENT AND COLLECTION.

Except as provided in section 276—

(a) *General Rule.*—The amount of income taxes imposed by this title shall be assessed within three years after the return was filed,

and no proceeding in court without assessment for the collection of such taxes shall be begun after the expiration of such period.

* * * * *

(c) *Amission from Gross Income*.—If the taxpayer omits from gross income an amount properly includible therein which is in excess of 25 per centum of the amount of gross income stated in the return, the tax may be assessed, or a proceeding in court for the collection of such tax may be begun without assessment, at any time within 5 years after the return was filed.

* * * * *

(U. S. C., Title 26, Sec. 275.)

Revenue Act of 1936, c. 690, 49 Stat. 1648:

SEC. 162. NET INCOME.

The net income of the estate or trust shall be computed in the same manner and on the same basis as in the case of an individual, except that—

(a) There shall be allowed as a deduction (in lieu of the deduction for charitable, etc., contributions authorized by section 23 (o)) any part of the gross income, without limitation, which pursuant to the terms of the will or deed creating the trust, is during the taxable year paid or permanently set aside for the purposes and in the manner specified in section 23 (o), or is to be used exclusively for religious, charitable, scientific, literary, or educational purposes, or for the prevention of cruelty to children or animals, or for the establishment, acquisition, maintenance or operation of a public cemetery not operated for profit;

* * * * *

10
United States
Circuit Court of Appeals

For the Ninth Circuit.

**JOHN THOMAS COLE and OMEGA TRICE
COLE,**

Appellants,

vs.

**HOME OWNERS' LOAN CORPORATION, a
Corporation,**

Appellee.

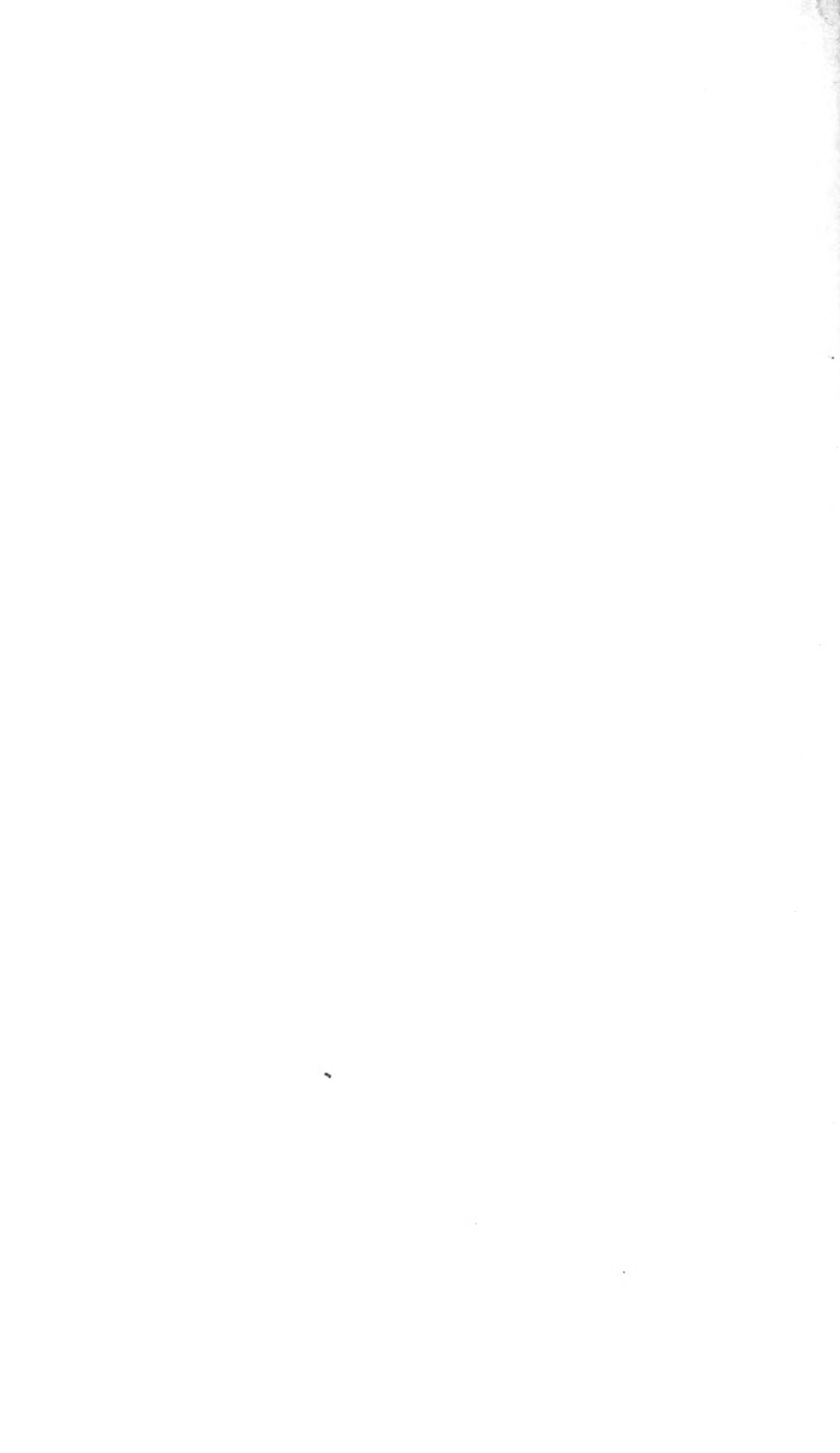
Transcript of Record

**Upon Appeal from the District Court of the United
States for the Eastern District of Washington,
Northern Division**

FILED

OCT - 1 1941

**PAUL F. O'BRIEN,
CLERK**



United States
Circuit Court of Appeals

For the Ninth Circuit.

JOHN THOMAS COLE and OMEGA TRICE
COLE,

Appellants,

vs.

HOME OWNERS' LOAN CORPORATION, a
Corporation,

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Transcript of Record

Upon Appeal from the District Court of the United
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INDEX

[Clerk's Note: When deemed likely to be of an important nature, errors or doubtful matters appearing in the original certified record are printed literally in *italic*; and, likewise, cancelled matter appearing in the original certified record is printed and cancelled herein accordingly. When possible, an omission from the text is indicated by printing in *italic* the two words between which the omission seems to occur.]

	Page
Ajudication in Bankruptcy.....	13
Appeal:	
Bond on	61
Designation for Record on (Circuit Court of Appeals)	69
Designation for Record on (District Court)	64
Notice of	60
Statement of Points on (Circuit Court of Appeals)	69
Statement of Points on (District Court).....	66
Answer to Petition for Review.....	36
Bond for Costs on Appeal.....	61
Certificate of Clerk to Transcript of Record on Appeal	67
Debtor's Amended Petition Under Sec. 75(s)	8
Demurrer to Petition for Review.....	34
Designation of Record on Appeal (Circuit Court of Appeals).....	69
Designation of Record on Appeal (District Court)	64
Docket Entries of All Proceedings Before U. S. District Court	2

	Page
Exceptions of Farm Debtor to Order of 4/16/41	54
Inventory and Appraisement.....	17
Minute Entries of Hearing of 10/7/40.....	58
Minute Entries of Hearing of 10/8/40.....	59
Minute Entries of Hearing of 4/16/41.....	60
Names and Addresses of Attorneys of Record	1
Notice of Appeal.....	60
Opinion, Memorandum, of the Court.....	39
Order Appointing Appraisers.....	16
Order Approving Appraisal.....	35
Order Approving Report of Conciliation Commissioner and Terminating Proceedings Before Him	7
Order Granting Motion for Extension of Time	63
Order of April 16, 1941.....	49
Order of General Reference.....	13
Order Setting Aside Exemptions.....	20
Petition, Debtor's Amended under Sec. 75(s).....	8
Petition (for Review).....	22
Petition to Set Aside Exemptions.....	14
Statement of Points on Appeal (Circuit Court of Appeals)	69
Statement of Points on Appeal (District Court)	66
Stipulation of 8/16/40.....	35
Stipulation of 5/23/41.....	57
Substitution of Attorneys.....	56

NAMES AND ADDRESSES OF
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Seattle, Washington
Attorneys for Home Owners' Loan Corporation

D. C. 117

BANKRUPTCY DOCKET

TITLE OF CASE Cause No. B-7900	CASH RECEIVED AND DISBURSED		
	1939 Date	Received	Disbursed
In the Matter of JOHN THOMAS COLE and OMEGA TRICE COLE, Farm Debtors—Bankrupts	Dec. 2 “ 30	A. N. Corbin Trans. Vou. #2	10.00
(Proceedings filed under Section 75)	1941 May 23 Jun 30	Carl B. Luckeraeth Tr 4	5.00
P. O. Address: East Wenatchee, Douglas County, Wash.			
REFEREE & TRUSTEE	ATTORNEYS		

Conciliation Commissioner: A. N. Corbin, Wenatchee, Wash.
—Referee for Farm Debtors—Bankrupts

JOHN McKAY, Carl B. Luckeraeth, 1308 Northern Life Tower, Seattle
Waterville, Wash. for Appellants to CCA (Farm Debtors—Bankrupts)

Russell F. Stark and Tom S. Patterson, 448 Dexter-Horton
Bldg., Seattle

Trustee— for Home Owners' Loan Corporation, Creditor

DATE	PROCEEDINGS	
1939		
Dec. 2	Petition for Composition or Extension under Sec. 75	12/2/39 10.00
" 2	Clerk's Order Approving Petition as properly filed	
" 2	Clerk's Order of Reference to Conciliation Commissioner	
1940		
Mar. 5	Report of Conciliation Commissioner (No Composition)	
9	Order Approving Report of Conciliation Commissioner and Terminating Proceedings before him	GOB-13-609
" 9	Pay Voucher CC certified, approved, and forwarded to Dept.	
" 9	Amended Petition under Section 75s	
" 9	Adjudication in Bankruptcy	GOB-13-606
" 9	Reference to John McKay, Referee	GOB-13-606
" 28	Petition to Set Aside Exemptions	
" 28	Order of CC appointing Appraisers (Dated 3/12/40)	
" 28	Inventory and Appraisement	
" 28	Order of CC Setting Aside Exemptions (Dated 3/13/40) and fixing Rents	
" 28	Petition of Farm Debtors to Borrow Money for Farm Operations, 1940	
" 28	Order of CC Authorizing Farm Debtors to Borrow Money for Farm Operations during year 1940 and to Secure same by Mortgage on Growing Crops	

[1*]

PROCEEDINGS

DATE

1940

- Apr. 26 Petition of Farm Debtors to Borrow Money for Farm Operations,
1940
- " 26 Order of Referee Authorizing Farm Debtors to Borrow Money
(2100.00 Additional)
- July 8 Petition HOLC for review of all orders entered by CC, for Order
authorizing sale of R. E., appointing Trustee, etc.
- July 24 Affidavit of Service of Petition for Review on John Thomas Cole
- " 24 Affidavit of Service of Petition for Review on Omega Trice Cole
- " 29 Demurrer to Petition for Review of HOLC filed by FD
- Apr. 13 Order of Conciliation Commissioner approving Appraisal
- " 28 Stipulation HOLC and Bkpts. "above captioned matter" to be
heard in Seattle at such time as assigned
- Oct. 7 Notice to Produce Original letter McKay to HOLC
- " 7 Answer Farm Debtor to Petition for Review of HOLC
- " 7 Praecipe for Subpoena to Witness, Douglas, et al, for F.D.s
- " 7 Hearing before Judge Black at Seattle (Petr's Exs 1 to 5)
- " 8 Copy of Minutes of Hearing in Seattle Oct. 7
- " 9 Copy of Minutes of Hearing in Seattle Oct. 8—Advisement

*Page numbering appearing at foot of page of original certified
transcript of Record.

PROCEEDINGS

DATE

1941

- | | | |
|------|----|--|
| Feb. | 7 | Order that all matters hereafter presented shall be presented to and determined by the Hon. Lloyd L. Black
GOB-13-833 |
| " | 26 | Opinion of Hon. Lloyd L. Black (Order in conformity therewith to be presented after notice) |
| Apr. | 7 | Petition of Debtors for authority to borrow money and to execute notes and mortgage as security therefor |
| " | 7 | Order of Referee authorizing loan and execution of notes and mortgage (Frank B. Malloy, Referee under Sec. 75s) |
| " | 17 | Notice of Presentment of Order (HOLC) at Seattle 4/14, 9 o'el |
| " | 17 | Objections and Exceptions of FD to proposed order |
| " | 17 | Proposed Order on Petition of HOLC (unsigned) |
| " | 17 | Minutes of Hearing on Petition of HOLC, Seattle, 4/16, 9 o'el |
| " | 17 | Order on Petition of HOLC signed
GOB-13-904 |
| May | 20 | Substitution of Attorneys for Debtors, Carl B. Luckerath for A. N. Corbin |
| " | 20 | Notice of Presentment and Request for Special Hearing on Petitioner's motion for order vacating and setting aside or modifying order entered 4/16/41 |
| " | 20 | Affidavit of Carl B. Luckerath in support of Request for Special Hearing |
| " | 20 | Motion FD for Order vacating and setting aside or modifying Order and Decree of 4/16/41 |

DATE	PROCEEDINGS	
1941		
May 20	Affidavit FD, John Thomas Cole, re impossibility to make timely motion for new trial	
“	20 Affidavit of A. N. Corbin, former attorney for FD re his proceedings concerning order of 4/16/41, etc.	
“	23 Stipulation re filing of notice of appeal, etc., with Clk. U. S. Dist. Ct., West. Dist. of Wash.	
“	23 Notice of Appeal by Farm Debtor to CCA	5/23/41 5.00
June 16	Bond for Costs on Appeal—Personal Surety \$250.00 to HOLC	
“	25 Motion FD for Extension of Time of filing for docketing Record on Appeal to CCA	
“	25 Order Extending Time to and including 8/1/41	GOB-13-989
		Forwarded to next page (3) [2]
July 18	Statement of Points on Appeal (FD Petitioners)	
“	18 Designation of Record to be included in transcript	
“	25 Petition HOLC for immediate sale of Property as provided in Order 4/16/41 (filed 4/17/41)	[3]

In the District Court of the United States for the
Eastern District of Washington, Northern
Division

In Bankruptcy

No. B-7900

In the Matter of

JOHN THOMAS COLE and
OMEGA TRICE COLE,

Farm Debtors

ORDER APPROVING REPORT OF CONCILIA-
TION COMMISSIONER AND TERMINAT-
ING PROCEEDINGS BEFORE HIM.

This matter coming on for hearing upon the report of the Conciliation Commissioner, which report shows that the above mentioned debtors have failed in effecting an extension with their creditors, as more fully appears from said report of the Conciliation Commissioner on file herein, and the Court being fully advised in the premises,

It Is Hereby Ordered, Adjudged and Decreed, that the report of the Conciliation Commissioner herein be, and the same is hereby, in all respects approved, and the proceedings before the Conciliation Commissioner terminated.

Dated this 9th day of March, 1940.

LLOYD L. BLACK

District Judge

[Endorsed]: Filed Mar. 9, 1940. [4]

AMENDED DEBTOR'S PETITION

(B-7900—5:00 P. M.)

In Proceedings Under Section 75 Sub-Section S
of the Bankruptcy Act

To the Honorable Judge of the District Court of
the United States for the Northern Division,
Eastern District of Washington:

The Petition of John Thomas Cole and Omega Trice Cole of East Wenatchee, in the County of Douglas and District and State of Washington (Occupation, Trade, or Business of) Farmers Respectfully Represents: That he & she is personally bona fide engaged primarily in farming operations as follows:

That they own and operate an orchard on the following described land in Douglas County, Washington:

Lot Three (3), Block Two (2), Eden Orchard Tracts, according to the plat thereof recorded in Volume B of plats, page 10, records of said County, Situate in the County of Douglas, State of Washington.

That such farming operations occur in the county (or counties) of Douglas, within said judicial district; that they are insolvent (or unable to meet their debts as they mature); that they have filed a petition (official form No. 65) under Section 75 of the acts of Congress relating to bankruptcy;

1*—that they have failed to obtain the acceptance of a majority in number and amount of all creditors whose claims were effected by a composition and/or extension proposal; and that they desire to obtain the benefit of Section 75 Sub-section S of the acts of Congress relating to Bankruptcy.

2*—[Not filled in]

That the schedule hereto annexed, marked "A", and verified by your petitioner's oath contains a full and true statement of all his debts, and (so far it is possible to ascertain) the names and places of residence of their creditors, and such further statements concerning said debts as are required by the provisions of said act.

That the schedule hereto annexed, marked "B", and verified by your petitioner's oath, contains an accurate inventory of all their property, both real and personal, and such further statements concerning said property as are required by the provisions of said act.

Wherefore Your Petitioners Pray, That they may be adjudged by the court to be *a* bankrupts in accordance with acts relating to Bankruptcy and all acts amendatory thereof, and that appraisers may be appointed to appraise all their property real and personal.

JOHN THOMAS COLE

OMEGA TRICE COLE

Petitioners

A. N. CORBIN

Attorney for Petitioner

Coupeville, Washington

United States of America,
 Eastern District of Washington—ss.

I, John Thomas Cole and Omega Trice Cole, the
 Petitioning debtor mentioned and described in the
 foregoing petition, do hereby make solemn oath that
 the statements contained there in are true accord-
 ing to the best of my knowledge, information and
 belief.

JOHN THOMAS COLE

OMEGA TRICE COLE

Petitioner

Subscribed and sworn to before me, this 23 day
 of February, A. D. 1940.

[Seal]

J. FRED WRIGHT

Notary Public [5]

SCHEDULE A

CREDITORS HOLDING SECURITIES

Home Owner's Loan Corporation—Seattle, Wash- ington	\$10,649.85
M. J. Trice, Wenatchee, Washington—Chattel Mortg.	1,200.00
Fruit Growers Service Co.—Wenatchee, Washington	2,000.00
Total.....	<hr/> 13,849.85

JOHN THOMAS COLE

OMEGA TRICE COLE

Petitioners

United States of America,
State of Washington,
County of Douglas—ss.

We, John Thomas Cole and Omega Trice Cole, the persons who subscribed to the foregoing schedule, do hereby make solemn oath that the said schedule is a statement of all our debts, in accordance with the Act of Congress relating to bankruptcy, according to the best of my knowledge, information, and belief.

JOHN THOMAS COLE
OMEGA TRICE COLE

Petitioners

Subscribed and sworn to before me this 23 day of February, A. D. 1940.

[Seal]

J. FRED WRIGHT

Notary Public residing at Wenatchee [6]

SCHEDULE B

Real Estate

Lot Three (3), Block Two (2), Eden Orchard Tracts, according to the plat thereof recorded in Volume B of plats, page 10, records of said County, Situate in the County of Douglas, State of Washington.

Personal Property

Household Goods

(Itemized list of furniture and personalty)

Farm Equipment
(Itemized list of farm equipment)

Bunk House
(Itemized list of furniture and personal property)

Keepsakes
(Itemized list of personal articles)

JOHN THOMAS COLE
OMEGA TRICE COLE

Petitioners [7]

OATH TO SCHEDULE B

United States of America,
State of Washington,
County of Douglas—ss.

We, John Thomas Cole and Omega Trice Cole, the persons who subscribed to the foregoing schedule, do hereby make solemn oath that the said schedule is a statement of all my property, real and personal, in accordance with the Act of Congress relating to bankruptcy, according to the best of my knowledge, information, and belief.

JOHN THOMAS COLE
OMEGA TRICE COLE

Petitioners

Subscribed and sworn to before me this 23 day of February, A. D. 1940.

[Seal]

J. FRED WRIGHT

Notary Public residing at Wenatchee.

[Endorsed]: Filed Mar. 9, 1940. [8]

[Title of District Court and Cause.]

ADJUDICATION OF BANKRUPTCY

At Spokane, in said district, on the 9th day of March, 1940.

The amended petition of John Thomas Cole and Omega Trice Cole, filed on the 9th day of March, 1940, that they be adjudged bankrupt under Section 75s the acts of Congress relating to bankruptcy, having been heard and duly considered;

It is adjudged that the said John Thomas Cole and Omega Trice Cole are bankrupt under the said act of Congress relating to bankruptcy.

LLOYD L. BLACK

District Judge.

GOB-13-606

[Endorsed]: Filed Mar. 9, 1940. [9]

[Title of District Court and Cause.]

ORDER OF GENERAL REFERENCE

At Spokane, in said district, on the 9th day of March, 1940.

Whereas an amended petition was filed in this court, on the 9th day of March, 1940, by John Thomas Cole and Omega Trice Cole, of East Wenatchee, Douglas Co., Wash., bankrupts above named, praying that they be adjudged bankrupt under Section 75s of the Bankruptcy Act as Amended, of the Acts of Congress relating to bankruptcy; and

whereas the said John Thomas Cole and Omega Trice Cole were adjudged bankrupt, upon said amended petition on the 9th day of March, 1940;

It is ordered that the above entitled proceeding be, and it hereby is, referred to John McKay, Esq., at Waterville, Washington, one of the referees in bankruptcy of this court, under said Section, to take such further proceedings therein as are required and permitted by said Act, and that the said John Thomas Cole and Omega Trice Cole shall henceforth attend before the said referee and submit to such orders as may be made by him or by a judge of this court relating to said bankruptcy.

LLOYD L. BLACK

District Judge.

G.O.B. 13-606

[Endorsed]: Filed March 9, 1940. [10]

[Title of District Court and Cause.]

PETITION TO SET ASIDE EXEMPTIONS

To John McKay, Conciliation Commissioner:

Comes now the above named bankrupts and petition the Court that there be set off to them their unencumbered exemptions and their unencumbered interest or equity in exemptions as prescribed by the laws of the State of Washington, said unencumbered exemptions being set out and described in Schedule

B-2, Exhibits A, B and C as shown in their debtors' petition in bankruptcy under Section 75 of the Bankruptcy Act, and also set out in the amended debtors' petition, Schedule B.

They further pray that remainder of debtors' property, to-wit:

Lot Three (3), Block Two (2), Eden Orchard Tracts, according to the plat thereof recorded in Volume B of plats, page 10, records of said County, Situate in the County of Douglas, State of Washington,

which is encumbered, but on which they have heretofore, to-wit: on the 20th day of October, 1924 filed a Declaration of Homestead under the laws of the State of Washington, shall remain in their possession under the supervision and control of the Court, subject to existing mortgages, and that the Court fix a reasonable rental to be paid semi-annually for said encumbered real estate.

That the Court make such other further orders as may be just and equitable in the premises.

JOHN THOMAS COLE

OMEGA TRICE COLE

Bankrupts

A. N. CORBIN

Attorney for Bankrupts

Address and P. O. Address:

Coupeville, Washington

United States of America,
Eastern District of Washington,
Northern Division—ss.

I, John Thomas Cole and Omega Trice Cole, the petitioners mentioned and described in the foregoing petition, do hereby make solemn oath that the statements contained therein are true according to the best of their knowledge, information and belief.

JOHN THOMAS COLE

OMEGA TRICE COLE

Subscribed and sworn to before me this 1st day of March, A. D. 1940.

[Seal]

FRANK B. MALLOY

Notary Public in and for the State of Washington,
residing at Waterville

[Endorsed]: Filed Mar. 28, 1940. [12]

[Title of District Court and Cause.]

ORDER APPOINTING APPRAISERS

This matter coming on on this 12th day of March, A. D. 1940, on the amended petition and the petition for appointment of appraisers by the said bankrupts, it is ordered that D. D. Hizey, L. E. Bradbury, and H. L. Douglas be and they hereby are appointed appraisers to appraise the estate of the said bankrupts as shown by the schedules in the

petition, amended petition, and inventory on file herein.

Dated this 12th day of March, A. D. 1940.

JOHN McKAY

Conciliation Commissioner

[Endorsed]: Filed Mar. 28, 1940. [13]

[Title of District Court and Cause.]

INVENTORY AND APPRAISEMENT

State of Washington,
County of Douglas—ss.

John Thomas Cole and Omega Trice Cole of the above entitled Estate each being first duly sworn on his and her oath, says that the within is a true Inventory of all the Estate, Real, Personal and Mixed, of said bankrupts.

JOHN THOMAS COLE

OMEGA TRICE COLE

Subscribed and sworn to before me this 12th day of March, 1940.

[Seal]

FRANK B. MALLOY

Notary Public in and for the State of Washington,
residing at Waterville.

State of Washington,
County of Douglas—ss.

D. D. Hizey, L. E. Bradbury, H. L. Douglas duly appointed appraisers of the above entitled estate,

being duly sworn, each for himself says: I will honestly and impartially appraise the property of said estate, which shall be exhibited to me according to the best of my knowledge and ability.

L. E. BRADBURY

DALE D. HIZEY

H. L. DOUGLAS [14]

Subscribed and sworn to before me this 12 day of March 1940.

[Seal]

J. FRED WRIGHT

Notary Public in and for the State of Washington,
residing at Waterville.

INVENTORY OF PROPERTY OF SAID BANKRUPTS
REAL ESTATE

Appraised
Value

Lot Three (3), Block Two (2), Eden Orchard Tracts,
according to the plat thereof recorded in Volume
B. of plats, page 10, records of said County, Situ-
ate in the County of Douglas, State of Washington.

Said property is subject to a mortgage to the
Home Owner's Loan Corporation in the sum of
Eleven Thousand One Hundred Ninety-Five and
no/100 Dollars (\$11,195.00)

PERSONAL PROPERTY

Household Goods

(Itemized list of personal articles)..... 428.00

FARM EQUIPMENT

(Itemized list of farm equipment)..... 425.50

KEEPSAKES

(Itemized list of personal articles).....

JOHN THOMAS COLE

OMEGA TRICE COLE

Petitioners

The real estate above mentioned above is claimed as exempt under declaration filed as stated in the original petition and claimed under sections 528, 552 and 558 Rem. Rev. Stat. All of the personal property described above is claimed as exempt under section 563 Rem. Rev. Stat. [15]

Total Appraised Valuation of Personal \$ \$
Estate

Total Appraised Valuation of Real
Estate

Total Appraised Valuation of Estate
Community Interest

We, the undersigned appraisers, do hereby certify that we have appraised the property described in the above inventory at \$853.50 for the personal property and \$1000.00 for the real estate, or a total of \$1853.50, the fair value thereof. Dated this 12 day of March, 1940.

L. E. BRADBURY

DALE D. HIZEY

H. L. DOUGLAS

Appraisers

[Endorsed]: Filed Mar. 28, 1940. [16]

[Title of District Court and Cause.]

ORDER SETTING ASIDE EXEMPTIONS

Now on this 13 day of March A. D. 1940, this matter came on for hearing on the farm debtors petition for an order setting aside to them their exemptions, and the court being advised in the law and the premises is hereby ordered that there be and hereby is set aside to said farm debtors the following unencumbered personal property which is claimed as exempt in the original petition in bankruptcy, and also under the amended petition on file in said cause, all of said property being claimed as exempt under the exemption laws of the State of Washington under the different subdivisions of Section 563, Remington's Revised Statutes, and also in accordance with Sections 75 of the Laws of the United States, Chapter 8, Provisions for the Relief of Debtors, and the different subdivisions thereof, to-wit:

Personal Property

Household Goods

(Articles listed under this heading are in Amended Debtor's Petition under Section 75 Sub-section S of the Bankruptcy Act.)

Farm Equipment

(Articles listed under this heading are in Amended Debtor's Petition under Section 75 Sub-section S of the Bankruptcy Act.) [17]

Bunk House

(Articles listed under this heading are in Amended Debtor's Petition under Section 75 Sub-section S of the Bankruptcy Act.)

Keepsakes

(Articles listed under this heading are in Amended Debtor's Petition under Section 75 Sub-section S of the Bankruptcy Act.)

And it is further ordered that the said farm debtors are the owners of:

Lot Three (3), Block Two (2), Eden Orchard Tracts, according to the plat thereof recorded in Volume B of plats, page 10, records of said County, Situate in the County of Douglas, State of Washington.

and that on or about October 20, 1924, the said farm debtors filed a Declaration of Homestead on said property; same being recorded in Volume 73, page 161, File No. 74011, under Sections 528, 530, 552, and 558 Remington's Revised Statutes, claiming said property as a homestead subject to encumbrances as shown in the petition and amended petition; be and the same is hereby set aside to said farm debtors, and that they shall have the possession of the same under the supervision and control of the court. That the property remain in the possession of said debtors subject to existing mortgages, liens, pledges, and encumbrances. That such mortgages and encumbrances shall remain in full force and effect.

It is further ordered that all judicial or official proceedings in any court or under the direction of any official against the debtors or any of their property shall be stayed for a period of three years, during which time the debtors shall be permitted to retain possession of all or any part of said property in the custody and under the supervision and control of the court provided that a reasonable rental shall be paid semi-annually for that part of the encumbered property of which the debtors [18] retain possession, and that the first payment of rental shall be made within one year from the date of this order, and shall be the usual and customary rental for such property, which rental is hereby fixed at the rate of 115.00 dollars per year.

Done in open court this 13 day of March, A. D. 1940.

JOHN McKAY

Conciliation Commissioner

[Endorsed]: Filed Mar. 28, 1940. [19]

[Title of District Court and Cause.]

PETITION

Petition of the Home Owners' Loan Corporation,
a corporation, respectfully states:

I.

That it is a Corporation duly incorporated pursuant to the provisions of the Home Owners' Loan

Act of 1933 and amendments. That on or about the 16th. day of February, 1934, the above named bankrupts applied to it for a loan pursuant to the provisions of said Home Owners' Loan Act and in support of his application for such loan stated and alleged that he was then the owner of the following described real estate:

Lot 3 of Block 2 of Eden Orchard Tracts according to the plat recorded in the office of the County Auditor of Douglas County, State of Washington,

subject to the following encumbrances: Mortgage to the estate of Anton Paukowich in the sum of \$5000.00 and mortgage to Fruit Growers' Service Company in the sum of \$8,500.00. That said encumbrances were either being foreclosed or were about to be foreclosed and that the said bankrupt was unable to refinance said liens from other sources and that unless a loan was made to the said bankrupt by petitioner, the liens on the above described real estate would be foreclosed and said real estate wholly lost to said bankrupt. [20]

II.

That thereupon petitioner caused said application to be processed in accordance with the law and the regulations of petitioner and caused the said above described real estate to be appraised in the manner provided by its regulations and rules, and the same was thereupon appraised as of the value of \$14,000.00 and that thereupon the petitioner advanced

the *same* of \$11,195.00 for the purpose of refunding the existing liens on the above described real estate and received as security for such advances a mortgage upon said above described real estate, a true copy of which is hereto attached, marked "Exhibit A" and made a part hereof. That said mortgage was duly acknowledged and duly recorded in the manner provided by law and at all times has been and now is a first lien upon the above described real estate, subject only to taxes and assessments thereon entitled to priority by the laws of the State of Washington.

III.

That no payments have ever been voluntarily made by the above named bankrupt upon said mortgage. That, however, in 1936, bankrupt applied to petitioner for an extension of time to January 1, 1937, in which to pay certain installments of said mortgage which were then past due, which request was granted and in consideration thereof gave to the petitioner a chattel mortgage on the 1936 crop of apples to be grown upon said above described real estate, and that as a result of said mortgage the petitioner received from the sale of the mortgaged crop on January 19, 1937, the sum of \$2,416.07 and on March 9, 1937 the additional sum of \$1,083.93, which sums were applied toward payment of the above [21] mentioned note and mortgage, and that in addition the petitioner has credited on said above mentioned note and mortgage on September 13, 1934 a refund of \$81.92 and on May 16, 1938, a refund

of \$2.07. That since the execution and delivery of said above mentioned mortgage and note the above named bankrupt has paid no taxes upon the above described real estate and has failed to procure fire insurance upon the buildings located on the mortgaged property, and that, accordingly, it became necessary for the petitioner to expend on the 25th. day of September, 1937, the sum of \$134.61 in procuring fire insurance and further to pay taxes upon the above described real estate at the following times and in the following amounts: On November 15, 1937 the sum of \$47.82; on the 21st day of March, 1938 the sum of \$575.25, and on the 28th day of February, 1940 the sum of \$29.13. That the above sums constituted the payment of all taxes due on the above mortgage since the date of its inception. That in addition thereto, petitioner has paid all taxes on the property involved since the year 1930 in an approximate amount, excluding the hereinabove mentioned sums, \$732.69. That in addition to the above, petitioner has paid all the water assessments from the year 1931 to date in an approximate amount of \$475.00. That in addition to the above amounts, petitioner was obliged to advance and did advance during the year 1936 the sum of \$603.72 for the care and maintenance of the orchard which is located on the mortgaged premises.

IV.

That petitioner is informed and believes and on information and belief alleges the fact to be that the

above named bankrupt purchased the above described real [22] estate on the 7th day of June, 1922, and incurred the obligations hereinbefore referred to in Paragraph #1. That prior to the 24th day of May, 1934, the bankrupt was unable to meet his obligation under the terms of the mortgage to the hereinabove mentioned estate of Anton Paukovich and as a result the said mortgage was foreclosed and a judgment rendered in favor of the said mortgagee on the 24th day of May, 1934. That execution under said judgment was issued and resulted in a sale by the Sheriff of Douglas County on the 30th day of June, 1934. That at said sale the mortgagee bid in the subject property for the sum of \$6,964.26. That petitioner at the time of the refunding which has been hereinabove mentioned, purchased the certificate of sale issued to said mortgagee from the said mortgagee at its full value. That in addition to the above, petitioner also refunded the mortgage of the Fruit Growers' Service Company, the entire refunding taking place on or about the 18th. day of July, 1934.

V.

That on or about the 13th day of October, 1939, the mortgage of petitioner on the above described real estate being then in default petitioner commenced an action in the Superior Court of Douglas County, Washington for the foreclosure of its above mentioned mortgage, and that the complaint in said action was duly filed in said court on the 13th day

of October, 1939, and that thereupon summons in said action to foreclose said mortgage was duly served upon all necessary and proper parties therein, service thereof being completed on the 27th day of October, 1939 and that upon said date the said Superior Court of Douglas County had full and Complete jurisdiction in [23] said foreclosure suit then pending before it.

VI.

That petitioner is informed and believes and on information and belief alleges the fact to be that on or about the 20th day of June, 1939, the above named bankrupt filed a voluntary petition for adjudication as a bankrupt in the District Court of the United States for the Eastern District of Washington (said petition and proceeding being a different petition and proceeding than that now pending before the above entitled court, the pending proceeding being Cause No. B-7900, records of the above entitled court, and the prior petition being Cause No. B-7832 of the records of the above entitled court), and that thereafter the above described real estate was in said proceeding No. B-7832 set aside to the above named bankrupt as exempt and subsequently on or about the 1st day of August, 1939 upon the petition of the above named bankrupt, granted on the 22nd day of September, 1939, the said above named bankrupts were discharged in bankruptcy.

VII.

That on or about the 2nd day of December, 1939 the above named bankrupt filed in the above entitled court, to-wit, the District Court of the United States for the Eastern District of Washington, Northern Division, their petition for a composition and extension of time under Section 75 of the Bankruptcy Act and that simultaneously therewith filed an offer to compromise the indebtedness then owing petitioner secured by a first mortgage upon the above described real estate, upon which there was then owing the sum of \$11,964.55, by payment to petitioner of the sum of \$880.00, and that said offer to compromise was rejected [24] by petitioner. Thereupon on or about the 9th. day of March, 1940 the above bankrupt filed in the above entitled court an amended petition praying that he be adjudged a bankrupt and have the benefits of Section 75(s) of the Bankruptcy Act. See Section 203(s) U. S. C. A. Thereupon the court entered an order to the effect that said petition was duly and timely filed and referred the matter to the Honorable John McKay, Conciliation Commissioner for Douglas County, Washington in said above mentioned district and division.

VIII.

That thereupon the said Conciliation Commissioner acting ex parte and without notice to petitioner, entered the following orders in said proceedings, to-wit: 1. Order staying all proceedings in any Court against the bankrupt or his property

for a period of three years. 2. An order appointing appraisers. 3. An order directing that during the above mentioned three year period the debtor shall be permitted to retain possession of all of his property under the supervision and control of the court. That subsequently without notice to petitioner or an opportunity to be heard the appraisers appointed by the said Conciliation Commissioner filed their report with the Commissioner wherein they appraised the above described real estate at the sum of \$1,000.00 and fixed the annual rental at \$115.00, and that thereupon on or about the 12th day of March, 1940, the above named Conciliation Commissioner ex parte and without notice to petitioner or an opportunity to be heard approved the report of said appraisers and fixed the value of the above described real estate at the sum of \$1,000.00 and the annual rental therefor at the sum of \$115.00, the same to be paid annually, i.e. one year from the date of said order. [25]

IX.

That petitioner is informed and believes and on information and belief alleges the fact to be that the present fair cash value of said mortgage and premises is in excess of the sum of \$5250.00. That said above described real estate is improved by a dwelling house estimated by petitioner to have cost new \$7,000.00 and believed and alleged to have been erected during the year 1927, which said dwelling house is in a fair state of repair. The above described real estate comprises 8.8 acres of land which

is improved by an apple orchard capable of yielding under normal conditions an apple crop of approximately 8,000 boxes per year.

X.

(Paragraph pertaining solely to entry of Order authorizing 1940 crop loan, which is not in issue on this appeal.)

XI.

That petitioner has reason to believe and does believe and on information and belief alleges the fact to be that there is no reasonable possibility of the above named bankrupt being able to rehabilitate himself and that the effect of allowing the bankrupt to retain possession of the above described real estate for a period of three years will be to cause great and irreparable loss to petitioner and will not on the contrary result in the rehabilitation of the bankrupt. That petitioner has reason to believe and does believe that if petitioner is allowed to proceed with its foreclosure suit and acquire title to said above described real estate that petitioner will be able to sell the same to others for not less than \$5,000.00. [26]

XII.

That the Conciliation Commissioner has heretofore appraised the household goods and personal property of the debtor at the value of \$428.00 and the farm equipment at the value of \$425.50. That petitioner has reason to believe and does believe and on information and belief alleges the fact to be that

said appraisals are excessively low and that further that a large part of the assets of the bankrupt, including but not limited to diamond rings, jewelry and silverware has not been appraised at all.

Wherefore, Petitioner prays,

First, That the court review all orders and proceedings in the above entitled cause heretofore had before the Conciliation Commissioner and enter such order or orders in said proceedings as to the honorable court may seem equitable, just and lawful.

Second, that the court enter an order authorizing the above described real estate to be sold at public auction in the manner provided by law.

Third, that the court enter an order amending the order of the Commissioner prohibiting further proceedings in the foreclosure suit heretofore brought by petitioner in the Superior Court of the State of Washington for Douglas County and permitting said suit to proceed.

Fourth, that the court enter an order appointing a trustee in the above entitled proceeding, requiring the trustee to give a bond and requiring that the proceeds of any and all loans or sales of any property of the bankrupt, including any crop grown on the above described real estate, be paid into the hands of said trustee, and that the same be disbursed by him under order of court, and that the net proceeds of any crops grown on the above described real estate remaining after paying therefrom the necessary costs of [27] production be applied toward the payment of taxes and assessments on the

above described real estate, necessary fire insurance thereon and the balance toward the mortgage of petitioner.

Fifth, that the court enter such other and further orders that may be just and equitable in the premises.

TOM S. PATTERSON

RUSSELL F. STARK

Attorneys for Petitioner

Office and Post Office Address:

448 Dexter Horton Building

Seattle, Washington

State of Washington,

County of King—ss.

A. C. Newell, being first duly sworn, on oath, deposes and says: That he is the Manager of the Washington State Agency of the Home Owners' Loan Corporation, petitioner in the above entitled action, and is duly authorized to make this verification on its behalf; that he has read the foregoing Petition for Review, knows the contents thereof and believes the same to be true.

A. C. NEWELL

Subscribed and Sworn to before me this 3rd day of July, 1940.

[Seal]

I. MOUNT

Notary Public in and for the State of Washington,
residing at Seattle [28]

EXHIBIT A

(Standard form of real estate mortgage prepared by Home Owners' Loan Corporation, executed July 18, 1934, by "J. T. Cole, also appearing of record as John Thomas Cole, and Omega Trice Cole, his wife, of the City of East Wenatchee, County of Douglas, hereinafter referred to as *the* "The Mortgagor" and Home Owners Loan Corporation, a corporation organized under and by virtue of the authority granted in H. R. 5240, designated as the "Home Owners' Loan Act of 1933", approved June 13, 1933, the Mortgagee, hereinafter referred to as "The Mortgagee", mortgaging the following described real property situate in the County of Douglas, State of Washington, to-wit:

Lot three (3), Block two (2), Eden Orchard Tracts, according to the plat thereof recorded in volume B of plats, page 10, records of said county. Situate in the County of Douglas, State of Washington;

to secure payment of \$11,195.00 with interest at five per cent. per annum on the unpaid balance in payments of \$88.53 monthly from date and authorizing the holder at his option to declare all the remainder of said debt due and collectible after default of any installment for more than ninety days.)

(The testimony of Charles R. Stark in support of alleged defaults recited in paragraph III of the complaint are not challenged).

(Signed on the above date by "J. T. Cole" and "Omega Trice Cole", whose signatures are acknowledged in form required July 19, 1934 by "Sam M. Driver", Notary Public in and for the State of Washington, residing at Wenatchee.) [29]

EXHIBIT B

(Copy of Order in above cause signed and dated April 25, 1940 by John McKay, Referee, authorizing bankrupts to borrow total of \$2500.00 on 1940 crop which raises no issue on this appeal.)

[Endorsed]: Filed July 8, 1940. [30]

[Title of District Court and Cause.]

DEMURRER

Come now the above named farm debtors and demur to the Petition for Review of the Home Owners' Loan Corporation on file in the above entitled cause and for the following reasons:

1. For the reason that said Petition for Review does not state facts sufficient to entitle the petitioner to a review of the proceedings referred to therein.

2. That the said proceedings were not commenced within the time limited by law.

A. N. CORBIN

Attorney for Farm Debtors

Office and Post Office Address:

Coupeville, Washington.

[Endorsed]: Filed July 29, 1940. [31]

[Title of District Court and Cause.]

ORDER APPROVING APPRAISAL

It appearing to the court that the appraisal of the farm debtor's property by appraisers duly appointed and qualified was filed before the undersigned on the 12th day of March, 1940, and it appearing to the court that said appraisal is the fair and reasonable market value of said property, and that the same should be approved,

It Is Therefore Ordered that said appraisal be and the same hereby is approved.

Dated this 12th. day of August, A. D. 1940.

JOHN McKAY

Conciliation Commissioner

[Endorsed]: Filed Aug. 13, 1940. [32]

[Title of District Court and Cause.]

STIPULATION

It is hereby stipulated between the Home Owners' Loan Corporation by its Assistant State Counsel, Russell F. Stark, Petitioner in the above matter, and John Thomas Cole and Omega Trice Cole by A. N. Corbin, their attorney, the bankrupts in the above matter, that the petition of the petitioner Home Owners' Loan Corporation now pending in the above captioned matter may be argued before one of the honorable judges of the above entitled

court in Seattle, Washington, at such time as may be assigned.

Dated this 16 day of Aug. 1940.

HOME OWNERS' LOAN
CORPORATION

By RUSSELL F. STARK

Its Assistant State Counsel
A. N. CORBIN

Attorney for John Thomas
Cole and Omega Trice Cole,
Farm Debtors

[Endorsed]: Filed Aug. 28, 1940. [33]

[Title of District Court and Cause.]

ANSWER TO PETITION FOR REVIEW

Comes now the firm that is above named and for answer to the petition for review of the Home Owners' Loan Corporation, a corporation, states:

I.

For answer to paragraph I and II, allege that they have not sufficient knowledge and information to form a belief as to the truth of the allegations therein contained and therefore denied the same.

II.

For answer to paragraph III of said petition for review, Farm Debtors admit that an extension of

time was given and further say that they have not sufficient knowledge and information as to the rest of the paragraph to form a belief as to the truth of the allegations therein contained.

III.

For answer to paragraph IV as a whole, state that they have not sufficient knowledge to form a belief as to the truth of the allegations therein contained.

IV.

For answer to paragraph VIII, admit all of said paragraph except they deny that the conciliatory commissioner acted *ex-party* as to all of said proceedings and denies specifically that the commissioner of the Home Owners Loan Corporation, a corporation, did not have notice that the said property had been appraised and the amount it had been appraised for and further [34] admits that the report of the appraisal was approved by the conciliations commissioner by accepting the same and sending all the papers to the U. S. District Court of Spokane, Washington and further admits that later, with the knowledge of said commissioner's said written offer to the said court approving the said appraisal.

V.

Denies each and every allegation in paragraph IX except that there is a dwelling house on said premises and that it is located on 8 and 8/10 acres of land on which there is an apple orchard and that

under normal conditions produces a crop as stated in said petition for review.

VI.

For answer to paragraph 10 admit that an order was made by said conciliated commissioner to mortgage the crop of apples growing on said premises and that said Farm Debtors did mortgage the same and denies each and every allegation in said paragraph contained.

VII.

For answer to paragraph 11 denies each and every allegation therein contained.

Admits first sentence of paragraph twelve and denies the remainder of said paragraph. [A.N.C. 10/8/40 J.G.C. 10/8/40]

Therefore, said Farm Debtors pray:

1. That the Petition of the said Home Owners' Loan Corporation, a corporation be denied.
2. That the Farm Debtors recover their costs and disbursements, herein together with a reasonable attorneys fee to be fixed by the court.

A. N. CORBIN

Atty. for Farm Debtors

[Endorsed]: Filed Oct. 7, 1940. [35]

United States District Court
Eastern District of Washington
Northern Division
In Bankruptcy
No. B-7900

In the Matter of

JOHN THOMAS COLE and
OMEGA TRICE COLE,

Farm Debtors.

MEMORANDUM OPINION

Whatever the technical situation of this proceeding might be under the pleadings or whatever the technical authority of the Court might be if the statutes relating to this matter had been strictly followed in so far as they fix procedure, clearly the parties, by their respective courses of action, including stipulations and submission of testimony, in fact authorized this court to now fix the value of the farm lands of the farm debtors and the conditions and time for redemption at that value by the farm debtors, and to determine whether there should be a sale in the event no redemption should be had.

It was stipulated in open court at the beginning of the hearing that included in the matter to be considered the court might have before it on review such approval as the Conciliation Commissioner made of the appraisal and rental, regardless of whether the approval of the Conciliation Commissioner as to the appraisal and the rental may have been made on the 9th of March, 1940 or in August,

1940, or whether at some intervening date, and whether it was in writing or orally.

And regardless of what may have been the technical rights of the parties to introduce new evidence to supplement the record of the Conciliation Commissioner and the appraisers both sides at the hearing before this court did introduce a substantial amount [36] of oral evidence. Considerable documentary evidence was also introduced. The farm debtors prior to the hearing subpoenaed and had in attendance several witnesses who testified at considerable length as to their respective opinions in connection with the market or rental value of the property, or both. During the hearing it was stipulated that a certain appraiser of the petitioner, Home Owners' Loan Corporation, if personally present, would testify that he had been an appraiser of the petitioner since 1934, had appraised approximately forty thousand pieces of property in this state, most of which were for mortgage purposes but many with respect to sales, so applying all of his time for approximately six years; that it was the practice to sell on appraisals of such appraiser and that of two thousand properties acquired by the Home Owners' Loan Corporation between sixty and seventy-five per cent. had already been sold on such appraisals, with all of which he was familiar; that he had appraised this particular property and that its present fair and reasonable cash market value as of the time of the hearing and at the time of the appraisal by the appraisers was at least \$5,250.00.

The attorney for the farm debtors objected only as to the materiality of such testimony and as to the qualifications of the witness.

Certainly such testimony was material and the witness was qualified. The only question, of course, would be as to the weight, if any, that the court should accord to same.

The prayer of the petitioner's petition was that the court should review all orders and proceedings had before the Conciliation Commissioner and should enter such order or orders as to the Court seemed equitable, just and lawful, including among other relief prayed for, an order authorizing the real estate to be sold at public auction, and the appoint- [37] ment of a trustee.

As above mentioned, by the action of both parties preceding and during the hearing the proceeding became one for court decision upon evidence submitted and not merely for review.

The evidence submitted to the court established the following:

The real estate in question is an orchard tract of 8.8 acres in Douglas County three miles from Wenatchee. The farm debtors bought same in 1922 on a contract at a price of \$23,000.00 and thereafter certain improvements were placed thereon. Included in the improvements on the property is a modern house, besides a barn and a packing shed. The home has five rooms on the main floor in addition to such rooms as may be in the basement; it is fully modern with hardwood floors, electric and

water service, hot air heat, excellent plumbing. And it is surrounded by an especially attractive and expensive terraced rock garden and with trees and shrubbery.

Some time after the purchase in 1922 the farm debtors obtained a deed to the property and ultimately placed two mortgages thereon. By 1934 one of such mortgages had been foreclosed and the farm debtors thereupon made application to the Home Owners' Loan Corporation for a loan and such corporation paid off all of the encumbrances, including back taxes against the property. The amount advanced by the Home Owners' Loan Corporation was \$11,195.00 payable at the rate of \$88.53 per month. This amount was many thousand dollars less than the aggregate of the encumbrances which had been against the property and which in part had been retired by the Home Owners' Loan Corporation at a substantial discount. [38]

The farm debtors from 1934 paid none of such agreed monthly payments nor even the taxes or fire insurance but some amounts were received by the Home Owners' Loan Corporation through a crop mortgage, etc. The parties are in dispute as to whether this was voluntary on the part of the farm debtors or compelled.

At any rate the total amount due the Home Owners' Loan Corporation at the present time is substantially in excess of the \$11,195.00 advanced by the Home Owners' Loan Corporation in 1934 for the relief of the farm debtors.

In 1939 the farm debtors were adjudicated bankrupts in voluntary bankruptcy proceedings under the general bankruptcy laws and obtained their discharge. Subsequently these farm debtors filed a petition for relief as farm debtors under Section 75 of the Bankruptcy Act and failing to secure a composition and extension under agreement with the creditors such original proceeding was dismissed and the farm debtors filed a petition to be adjudged bankrupts under Section 75(s).

Thereafter appraisers appraised the real estate as having a fair and reasonable market value of \$1,000.00 and the Conciliation Commissioner ordered that the debtors should have possession of the real property for three years and should pay \$115.00 annually as rental. The Home Owners' Loan Corporation, feeling aggrieved, came to this court for relief, insisting, among other things, that the real property had an actual cash market value in excess of \$5,250.00. In normal years the orchard produces about eight thousand boxes of apples annually.

The farm debtor in his testimony before this court insisted under oath that the total value of the 8.8 acres, including orchard and all improvements, was \$880.00 and that [39] such was the value of the property free of all taxes and encumbrances whatsoever. His testimony, in effect, was that there was no rental value to the property at all other than taxes and water (LLB) and that he at the present time had the complete use and possession of four similar properties by merely paying the taxes and water or less and could secure additional orchards

under similar arrangements. The farm debtor further testified that he did not know and could not even estimate what the house cost, but that it was worth very little. His further testimony was that the original part of the house was very old, being an old settler's shack, that the new part was built around it about thirteen years ago as a makeshift and was in poor condition with the foundation giving way, the concrete being a poor job, with the floor not substantially built and with the roof in poor condition and leaking. No interpretation of his testimony concerning the house is possible except that the house had never been in good condition or repair or of any substantial value.

Other witnesses produced by the farm debtors indicated lack of knowledge as to the house but gave their various opinions of the value of the real estate for sale being between \$800.00 and \$2,000.00 (the higher figure being on terms) and for rent \$115.00 annually, upon the ground that the only market for sale or rent of orchard properties now or for many years past had been completely demoralized. The court believes these witnesses were in good faith but feels compelled by reason of the debtors' application of 1934 and petition of December, 1939, and other circumstances and evidence to accept the mortgagee's position as to the value of such tract. [40]

The written application for the loan signed by Mr. Cole in 1934 was to the effect that the house was then six years old, was in a good state of repair, was forty by thirty-eight feet and cost \$6,500.00;

that the barn cost \$300.00 and the packing shed \$750.00, and that the land cost \$23,000.00, or a total of \$30,550.00. From the exhibits introduced in the case undoubtedly the Howe Owners' Loan Corporation relied upon the representations of the farm debtor as to the house then being six years old, in good repair and that it cost \$6,500.00, instead of its being an ancient remodeled shack in poor repair with cost unknown. It accepted the property as representing a total investment of \$30,550.00 and of having a reasonable and fair market value in the demoralized market of 1934 of approximately \$14,000.00. And at the request of the farm debtor it advanced \$11,195.00 thereon.

Regardless of the debtor's testimony before the court the original petition signed by the farm debtor and his wife under oath on December 1, 1939 set forth that this orchard tract was subject to a mortgage for \$11,195.00 and that its value over and above encumbrances was \$2,000.00, thus making a total value of said tract of \$13,195.00 on December 1, 1939. All the evidence in the case was to the effect that there had been no change in value from long before December, 1939 to the date of hearing. It may be remarked in passing that the valuation by the farm debtors in the petition of December, 1939 was not much at variance with the \$14,000.00 valuation under which the Home Owners' Loan Corporation made its loan in 1934.

From the exhibits and testimony, including the photographs of the home and the surroundings the

court is compelled to the conclusion that a fair and reasonable market value [41] for the tract now is and at all times since these proceedings were instituted in December, 1939 has been at least \$5,250.00.

If the actual market is as demoralized as the farm debtors contend then a sale at \$880.00 or any substantial amount under \$5,250.00 would be a forced sale at a grossly unfair and unreasonably low price such as the Home Owners' Loan Act and the Farm Debtor statutes were intended to avoid.

Under the contentions and testimony of the farm debtor before the court the property not only has no real value or real rental value but there is no prospect of there being an increase in the future as to either. Under the farm debtor's testimony the property is of no use or moment to him as he not only is able to get but is actually in possession of four other properties. Under the evidence there is no possibility of rehabilitation of the debtors nor does his testimony permit inference that he expects or desires such.

If the farm debtor is in good faith in his representations of the worthlessness and uselessness of the property he should not be interested in whether it were appraised at \$880.00 or \$5,250.00. He contended that it does not and has not been producing enough for many years to even pay the taxes and water.

It is provided in Section 75 (s) that the rental shall be based upon the rental value, net income and earning capacity of the property and that "the

court, in its discretion," may, in addition to the rental, require payments on the principal due and owing by the debtor, etc.

The Court deems \$115.00 annually far below the rental value of the real estate and deems insufficient any annual rental less than \$400.00 for a property capable of producing about eight thousand boxes of apples during a normal season and with a modern
[42]

and attractive home as convenient to Wenatchee as this one. But since the debtors evidenced lack of interest in paying more than merely enough to cover taxes and water charges it does not appear necessary to the disposition of the property to fix the proper rental.

As provided in Section 75 (s) and pursuant to the decision of James M. Wright, petitioner, vs. The Union Central Life Insurance Company, et al., United States Supreme Court, decided in December, 1940, the farm debtors shall have an opportunity to redeem such property at the value of \$5,250.00 fixed by the Court until the first day of May, 1941, and thereafter the court, at the petition of the mortgagee, will appoint a trustee and an immediate sale of the property will be had at public auction, under the provision that the mortgagee shall not be permitted to bid more than \$5,250.00 for said property and that the farm debtors shall have ninety days after such sale to redeem therefrom.

So long as the farm debtors properly care for said property and the orchard and improvements thereon and properly irrigate and spray the orchard

and pay therefor, they shall, until May 1, 1941, be entitled to the possession of said property and if they fail to redeem by said time shall, if immediate sale be ordered, continue to have such right so long as they comply with such requirement until the sale and until the ninety days for redemption thereafter has expired. However, the mortgagee, in order to protect its lien, shall also have the right at all such times to go upon said property (other than in the home while occupied by the farm debtors) and at its expense spray and irrigate same as may be reasonably necessary to preserve and protect the orchard and protect the value of said property. If sale is not had, as above, then the debtors shall [43] be required also to pay a proper rental to continue its possession.

The Court has very sincere sympathy for distressed farmers and those seeking an opportunity for rehabilitation under the provisions of Section 75 and 75 (s) and recognizes that under the law such farm debtors are usually entitled to possession of property for three years before a sale is had. But the provisions of this Act certainly under the facts here disclosed are not intended to totally destroy the loan of a party which in good faith came to the farm debtors' rescue upon his written representations which he later under oath attempts to show were false.

What the debtor seeks would destroy the loan and yet, if the debtor is in good faith, would benefit

the debtor not at all. The decision which the lender seeks will salvage less than half of the lender's loss and under the debtor's claim hurt the debtors not one whit.

The court is convinced that the debtor in fact does believe that the property is worth much in excess of \$5,250.00, and that his testimony that it was worth but \$880.00 was with the purpose of having that fixed as the value so that he, upon payment thereof, could secure the property at that unreasonably low price and thereby wipe out the \$11,195.00 encumbrance of the Home Owners' Loan Corporation created when it sought, at his request, to be the debtors' benefactor.

Order in conformity herewith is to be presented after notice.

Dated this 25th day of February, 1941.

LLOYD L. BLACK

United States District Judge.

[Endorsed]: Filed Feb. 26, 1941. [44]

[Title of District Court and Cause.]

ORDER

The above entitled cause came on to be heard on the petition of the Home Owners' Loan Corporation, which is on file herein, and the petitioner appeared by its attorneys of record, Mr. Tom S. Patterson and Mr. Russell F. Stark, and the Farm

Debtors, to-wit, John Thomas Cole and Omega Trice Cole, appeared in person and by their attorney of record, Mr. A. N. Corbin, and it was stipulated in open court that the court might hear and determine the issues presented by the petition of said Home Owners' Loan Corporation, and subsequent pleadings, upon their merits and that all objections to the form of procedure were waived and that the court might hear said matter and rule thereon at Seattle, Washington (such place being more convenient for the parties) with like effect as if the court were actually sitting at Spokane in the Eastern District of Washington, and each of the parties waived any and all objections to said matter being heard by the court at Seattle, and on the contrary joined in a request that the matter be heard there, and the court heard evidence on behalf of the respective parties and argument of counsel and thereupon briefs were submitted and the court took the matter under advisement, and subsequently rendered a memorandum opinion, which is on file herein and the court being thus duly advised in the premises, it is by the court [45] hereby ordered, adjudged and decreed as follows, to-wit:

I.

That the value of Lot Three (3), Block two (2) Eden Orchard Tracts, according to the plat thereof recorded in the office of the County Auditor of Douglas County, State of Washington, is hereby fixed at the sum of fifty-two hundred fifty and

00/100 (\$5250.00) Dollars; that a reasonable annual rental for the use of said property would be not less than four hundred and 00/100 (\$400.00) Dollars, but that inasmuch as the farm debtors have evidenced lack of interest in paying more than enough to cover taxes and water charges against the property it does not appear to the court necessary to the disposition of the property to fix the annual rental.

II.

That there is no possibility of rehabilitation of the farm debtors, nor does their testimony permit the inference that they expect or desire the same.

III.

That if the farm debtors shall, on or before May 1, 1941, pay into the Registry of the Court the sum of fifty-two hundred fifty and 00/100 (\$5250.00) Dollars they shall then be entitled to have turned over to them the full possession and title to the real estate described in Paragraph I hereof, free and clear of encumbrances.

IV.

That if the farm debtors shall not, prior to May 1, 1941, pay into the Registry of the Court the sum of Fifty-Two Hundred Fifty and 00/100 (\$5250.00) Dollars for the purpose of redeeming the property as provided in the preceding paragraph hereof, an immediate sale of the property described in Paragraph I hereof shall be had thereafter at public

auction by a Trustee to be appointed by the court upon petition of the Home Owners' Loan [46] Corporation, at which sale the Home Owners' Loan Corporation shall be allowed to bid, provided its bid shall not exceed Fifty-Two Hundred Fifty and 00/100 (\$5250.00) Dollars, and the farm debtors shall have ninety (90) days after such sale to redeem therefrom, and that if redemption be not had within said period all right, title, claim, lien and interest of the farm debtors and all persons claiming by, through or under them in or to the above described real property shall terminate and end, and the Trustee shall execute the proper conveyance conveying the title to the purchaser in fee simple, free and clear of any claims of the farm debtors therein or thereto whatsoever to the purchaser and thereafter the farm debtor shall be forever barred and estopped from asserting any right, title, claim, lien or interest whatsoever in or to said above described real estate. If the Home Owners' Loan Corporation shall elect to bid at said sale it shall not be required to pay the amount of its bid in cash but same may be paid by crediting the amount of its bid upon its mortgage debt.

V.

So long as the farm debtors properly care for said property and the orchard and improvements thereon and properly irrigate and spray the orchard and pay therefor, they shall, until May 1, 1941, be entitled to the possession of said property and if

they fail to redeem by said time shall, if immediate sale be ordered, continue to have such right so long as they comply with such requirement until the sale and until the ninety (90) days for redemption thereafter has expired. However, the mortgagee, in order to protect its lien, shall also have the right at all such times to go upon said property (other than in the home while occupied by the farm debtors) and at its expense spray and irrigate same as may be reasonably necessary to preserve and protect the orchard and protect the value of said property. If sale is not had, as above, then the debtors shall be required also to pay a proper rental to continue in possession. If in the opinion of the [47] Home Owners' Loan Corporation the farm debtors shall not properly farm, care for and cultivate said property and the orchard and improvements thereon and properly irrigate and spray and cultivate the same and pay therefor, the Home Owners' Loan Corporation shall have the right to apply to this court for an order authorizing it to enter into the possession, control and management of said property (other than the house occupied by the debtors) and to such other relief in the situation that may to the court at said time seem proper.

Done in open court this 16th day of April, 1941.

LLOYD L. BLACK

Judge

Presented by:

TOM S. PATTERSON

[Endorsed]: Filed Apr. 17, 1941. [48]

[Title of District Court and Cause.]

EXCEPTIONS OF FARM DEBTOR TO ORDER
OF 4/16/41

Come now the said Farm Debtors, by their Attorney, A. N. Corbin, of Coupeville, Washington, and object and except to the signing and entering of the Order prepared by Messrs. Tom S. Patterson and Russell F. Stark, attorneys for the petitioner, as follows:

First: That said order is contrary to the Laws of the United States pertaining to proceedings under the Amended Frazier Lempke Act, providing for relief for distressed Farm Debtors, under which said Farm Debtors are seeking relief.

Second: It is not supported by the preponderance of the evidence introduced. All of the three disinterested witnesses, to-wit, George A. Sellar, Harry Wycker and A. E. Yaeger placed the value about the same as the appraisers, from \$1000 to \$1200, with possible \$1200 to \$2000 with practically no down payment. Mr. Cole of course is an interested witness, but he placed the value approximately the same as the other named witnesses and at about the same sum fixed by the appraisers. His evidence is entitled to credit as he is corroborated by all the witnesses and the appraisers, excepting only the witness who counsel stated would testify that the place was worth \$5250, and that witness did not appear in court and there was no opportunity to cross examine him.

Third: Objects and excepts to all of paragraph I after the word "Dollars", in line 5 page 2 of the order, for the reason that no evidence was introduced to support that statement.

Fourth: Objects and excepts to all of paragraph "II" for the reason that there is no evidence to support that statement, and for the further reason that at the time the petition was filed and at the time of the hearing the Farm Debtors had been given no opportunity to rehabilitate themselves as provided by the laws above referred to. They had complied with the said law, had performed the orders of the court, and were not in default in any particular, and no one could say that there was no possibility of rehabilitation. That could be determined after the fruit was harvested and sold. The price of apples alone would determine that fact. Under the law they were entitled to three years to do that, unless they failed to pay the rental fixed by the appraisers, or neglected to take good care of the orchard involved in this controversy.

Fifth: Object and except to the order as a whole for the reason that the same is *contrary the* laws of the United States and is contrary to the evidence in the case and that it absolutely nullifies the said Frazier Lempke Act (Amended).

These objections are presented in writing for the reason that said Farm Debtors are unable financially to be represented personally.

Very respectfully submitted,

A. N. CORBIN

Attorney for Farm Debtors.

[Title of District Court and Cause.]

SUBSTITUTION OF ATTORNEYS

The undersigned, A. N. Corbin, attorney of record for the above named farm debtors, hereby withdraws as their attorney, and consents to the substitution of Carl B. Luckerath of Seattle Washington as Attorney of record for said farm debtors.

Dated this 15 day of May 1941.

A. N. CORBIN

ORDER ALLOWING SUBSTITUTION OF ATTORNEYS

On this 20th day of May, 1941, upon the foregoing consent of substitution of Attorneys being present to the court, in the above entitled matter.

It is hereby ordered that Carl B. Luckerath of Seattle Washington be substituted as Attorney of record for the Farm Debtors, John Thomas Cole, in the above entitled matter.

Dated this 20th day of May, 1941.

LLOYD L. BLACK

Judge

Presented by
CARL B. LUCKERATH

Copy received This 20 day of May 1941.

PATTERSON & PATTERSON

Atty's for Home Owners' Loan
Corporation

By D. Q.

[Endorsed]: Filed May 20, 1941. [51]

[Title of District Court and Cause.]

STIPULATION

It is hereby stipulated and agreed between the undersigned respective counsel for the above named farm debtors, and for petitioner, Home Owners Loan Corporation, that notice of appeal and other pleadings pertaining to the same may be filed with the Clerk of the United States District Court for the Western District of Washington, Northern Division, in Bankruptcy, with like effect and the same as though filed with the Clerk of the United States District Court for the Eastern District of Washington, Northern Division, in Bankruptcy.

This stipulation is entered upon for the convenience and accommodation of counsel, and for the reason that the files in the above entitled cause are presently held through transfer by the said Clerk of the United States District Court for the Western District of Washington, Northern Division, in Bankruptcy.

Dated and signed this 23rd day of May, 1941.

CARL B. LUCKERATH

Attorney for Farm Debtors

RUSSELL F. STARK

Attorney for Home Owners
Loan Corporation.

[Endorsed]: Filed May 23, 1941. [52]

Calendar

Hon. Lloyd L. Black, U. S.

District Judge.

Monday, October 7th, 1940.

* * * *

[Title of District Court and Cause.]

DEMURRER OF FARM DEBTORS TO
PETITION ON REVIEW

The matter is called at 8 a. m. It is stipulated in open Court by and between counsel that this Court may hear the matter here for the convenience of both sides with the same authority as if the court were sitting in Spokane, Wash. It is also stipulated in open court that this Court may have before it on review such approval as a conciliation commissioner made of the appraisal and rental regardless of whether suit may have been made on the 9th of March 1940 or in August or at some intervening date, or whether it was in writing or orally. Russell F. Stark is sworn and testifies. Petr's Exs 1 & 2 are offered, objected to & objection overruled, said exhibits are admitted. Petrs. Exs 3 & 4 are adm., there being no objections thereto. John Thos. Cole is sworn & testifies. Petrs. Ex No. 5 is adm., there being no objection thereto. At 10 A. M. matter cont'd to 8 A. M. tomorrow.

[Endorsed]: Filed Oct. 8, 1940. [53]

Calendar

Hon. Lloyd L. Black, U. S. District Judge,

Tuesday, October 8th, 1940.

8:00 A. M.

[Title of District Court and Cause.]

Further Hearing on Demurrer of Farm Debtors to Petition on Review, cause called for further hearing, all parties present. Mr. Cole resumes the stand and further testifies. Mr. Stark is recalled to the witness stand & further testifies. At 8:30 A. M. Petitioner rests. A. E. Yeager is sworn & testifies on behalf of the Farm Debtors. For the purpose of protecting any witnesses claim, either against the Farm Debtors or against the Petitioner, as the argument may be, the Court directs the record to show that this witness attended yesterday as a witness under subpoena as well as today, the witness being from Wenatchee, Wash. Mr. Patterson objects to certain portions of the testimony of Mr. Yeager, said objection being overruled. Geo. A. Sellar is sworn & testifies on behalf of the Farm Debtors Harry E. Weicker is sworn & testifies on behalf of the Farm Debtors. At 9:35 A. M. Farm Debtors rest. The argument is to be submitted on briefs—Farm Debtors to file opening brief within eight (8) days, Petitioners to file answering brief within eight days thereafter & Farm Debtors 5 days thereafter to reply.

[Endorsed]: Filed Oct. 9, 1940. [54]

Court Room No. 2, Wednesday, April 16, 1941—
9 A. M.

Present: Hon. Lloyd L. Black, U. S. Judge, Elmo
Bell, Dep. Clerk, Maloney & Holland, Bailiffs.

[Title of District Court and Cause.]

This matter comes on before the Court for the entry of an order on the hearing of the Petition of Home Owners' Loan Corp. The cause is called, statements are made by Mr. Patterson. Court directs the order proposed by Mr. Patterson and bearing the acceptance of counsel for the Farm Debtors be filed even tho it is not signed by the Court. Court further directs the exceptions of counsel for the Farm Debtors to the proposed order of the Petitioners be filed and such exceptions be noted as exceptions to the order to be presented at 2:00 P. M. today, at which time order is presented by Mr. Patterson & signed by the Court. Order and copy of this minute entry mailed to Spokane today. (E Bell).

[Endorsed]: Filed Apr. 17, 1941. [55]

[Title of District Court and Cause.]

NOTICE OF APPEAL

Notice is hereby given that the above named John Thomas Cole and Omega Trice Cole, farm debtors, hereby appeal to the Circuit Court of Appeals for the Ninth Circuit from the order of the court en-

tered herein by the Honorable Lloyd Black April 16, 1941, and from the whole thereof.

CARL B. LUCKERATH

Attorney for Appellants John
Thomas Cole and Omega
Trice Cole, Farm Debtors.

Post Office Address:

1308 Northern Life Tower
Seattle, Washington.

[Endorsed]: Filed May 23, 1941. [56]

[Title of District Court and Cause.]

BOND FOR COSTS ON APPEAL

Know All Men by These Presents, that we, John Thomas Cole and Omega Trice Cole, his wife, as principals, and Nina G. Blake as surety, are held and firmly bound unto Home Owners Loan Corporation, a corporation, in the sum of \$250.00, for the payment of which well and truly to be made we bind ourselves, our administrators, successors and assigns, jointly and severally, firmly by these presents.

Sealed with our seals and dated this 9 day of June, 1941.

Whereas, a certain order was entered herein on the 16th day of April, 1941, in a proceeding wherein Home Owners Loan Corporation, a corporation, was petitioner, and John Thomas Cole and Omega Trice

Cole, his wife, were respondents, and said respondents did on the 23rd day of May, 1941, file notice of appeal from said order as required by law, and

Whereas, a bond for costs on appeal in the sum of \$250.00, is required by law to be filed with the said notice,

Now Therefore, the condition of this obligation is such that if the said John Thomas Cole and Omega Trice Cole, his wife, shall pay all costs which may be awarded if the [57] said appeal is dismissed or the said order affirmed, and such costs as the Appellate Court may award if the said order is modified, then this obligation shall be void, otherwise the same shall be and remain in full force and virtue.

JOHN THOMAS COLE

OMEGA TRICE COLE

NINA G. BLAKE

State of Washington,
County of Chelan—ss.

On this 9 day of June, 1941, before me, the undersigned, a Notary Public in and for the State of Washington, duly commissioned and sworn, personally appeared John Thomas Cole and Omega Trice Cole, his wife, and Nina G. Blake to me known to be the individuals described in and who executed the foregoing instrument, and acknowledged to me that they signed and sealed the said instrument as their free and voluntary act and deed for the uses and purposes therein mentioned.

Witness my hand and official seal hereto affixed
the day and year in this certificate above written.

(Notarial Seal)

H. E. WIKER

Notary Public in and for the State of Washintgon,
residing at Cashmere.

[Endorsed]: Filed June 16, 1941. [58]

[Title of District Court and Cause.]

ORDER GRANTING MOTION FOR
EXTENSION OF TIME

The Court being fully advised, It Is Hereby Ordered, Adjudged and Decreed, that the motion of the Farm Debtors for an extension of time for Docketing and filing record on appeal in the above entitled matter in the United States Circuit Court of Appeals be, and the same is hereby granted and the time for the filing and docketing of such record is extended to and including August 1, 1941.

Dated this 25 day of June, 1941.

L. B. SCHWELLENBACH

United States District Judge.

[Endorsed]: Filed June 25, 1941. [59]

[Title of District Court and Cause.]

DESIGNATION OF RECORD TO BE
INCLUDED IN TRANSCRIPT

To the Clerk of the United States District Court for
the Eastern District of Washington, Northern
Division:

You Are Hereby requested to prepare, certify and transmit to the Clerk of the United States Circuit Court of Appeals for the Ninth Circuit, with reference to a Notice of Appeal heretofore filed by the petitioner in the above entitled action, a Transcript of the record in the above cause, prepared and transmitted as required by law and by the rules of said Court, and to include in said Transcript of record the following designated portions thereof, to-wit:

(1) The docket entries of all proceedings before the United States District Court in said Cause.

(2) Order approving report of Conciliation Commissioner and terminating proceedings before him.

(3) Amended Debtors' Petition in proceedings under Section 75, Subsection (s), of the Bankruptcy Act.

(4) Adjudication of bankruptcy.

(5) Order of General Reference.

(6) Petition to set aside Exemption.

(7) Order appointing appraisers.

(8) Inventory and Appraisement.

(9) Order setting aside exemption.

(10) Petition (for review).

- (11) Demurrer.
- (12) Order approving appraisal. [60]
- (13) Stipulation.
- (14) Answer to Petition (for review).
- (15) Written Memorandum Opinion of District Court.
- (16) Order of April 16, 1941.
- (17) Exceptions of Farm Debtors, by their attorney, A. N. Corbin, to entry of said Order, filed April 16, 1941.
- (18) Substitution of attorneys.
- (19) Stipulation of May 23, 1941.
- (20) Minute Entries on hearing of October 7th and 8th, 1940.
- (21) Minute Entries on April 16, 1941, granting exceptions to entry of order.
- (22) Notice of Appeal.
- (23) Bond for Costs on appeal.
- (24) Order granting motion for extension of time.
- (25) This Designation of the record on appeal.
- (26) Statement of points on appeal.

CARL B. LUCKERATH

Counsel for Petitioners

1208-1316 Northern Life Tower,
Seattle, Washington.

Copy Received This 17 day of July, 1941.

PATTERSON & PATTERSON

Atty's for Home Owners'

Loan Corporation.

[Endorsed]: Filed July 18, 1941. [61]

[Title of District Court and Cause.]

STATEMENT OF POINTS ON APPEAL

Come now John Thomas Cole and Omega Trice Cole, Farm Debtors and Petitioners in the above entitled cause, and present the following Statement of Points upon which they intend to rely upon their appeal from the decision of the United States District Court, made, and entered April 16, 1941, to-wit:

(1) Error in overruling petitioner's Demurrer to respondent's Petition (for review).

(2) That said order is contrary to the laws of the United States pertaining to pleadings under the Amended Frazier-Lempke Act (11 U. S. C. A., Sec. 203; Act of June 22, 1938, Chapter 575 (75 a to s, 52 Stat. 840)), providing for relief of distressed farm debtors, and under which petitioners are seeking relief.

(3) Failure of said order to fix an appraised value and a rental value in the manner prescribed by the said Amended Frazier-Lempke Act, and in failing to confirm petitioner's right to occupation and possession of the farm property involved for a period of three years, free from legal steps of ouster or dispossession, contingent on performance of and compliance with the order of the court with respect to rental and manner of occupation.

(4) That the recitals in said order of a valuation of \$5,250.00 is contrary to all the evidence [62] received, supported by no testimony whatever, as shown by the record of the trial and the opinion of the Court.

(5) That there is no evidence which was introduced to support the statement contained in that portion of Paragraph I of said Order, following the word "Dollars", in line 5, page 2, being Paragraph numbered I of said Order.

(6) That there is no support by evidence or testimony for the recital of Paragraph II of said Order.

CARL B. LUCKERATH

Counsel for Petitioners.

1308-1316 Northern Life Tower,
Seattle, Washington.

Copy Received This 17 day of July, 1941.

PATTERSON & PATTERSON

Atty's for Home Owners'
Loan Corporation.

[Endorsed]: Filed July 18, 1941. [63]

[Title of District Court and Cause.]

CERTIFICATE OF CLERK OF THE UNITED
STATES DISTRICT COURT TO TRAN-
SCRIPT OF RECORD.

United States of America,
Eastern District of Washington—ss.

I, A. A. LaFramboise, Clerk of the United States District Court for the Eastern District of Washington, do hereby certify the foregoing typewritten pages, numbered from 1 to 63 inclusive, to be a full,

true and correct copy of so much of the record, papers and proceedings in the above entitled cause as are necessary to the hearing of the appeal therein in the United States Circuit Court of Appeals as called for by the Designation of Record on Appeal of the appellant, as the same remains on file and of record in my office, and that the same constitutes the record on appeal from the order dated April 16, 1941 of the United States District Court for the Eastern District of Washington to the United States Circuit Court of Appeals, for the Ninth Judicial Circuit, at San Francisco, California.

I further certify that the fees of the Clerk of this court for preparing and certifying the foregoing record amount to the sum of \$10.15 and that the same has been paid in full by Mr. Carl B. Luckerath, Attorney for said Farm Debtor Appellants.

In Witness Whereof, I have hereunto set my hand and affixed the seal of said District Court, at Spokane in said District, this 30th day of July, A. D. 1941.

(Seal)

A. A. LaFRAMBOISE

Clerk of said District Court.

[64]

[Endorsed]: No. 9881. United States Circuit Court of Appeals for the Ninth Circuit. John Thomas Cole and Omega Trice Cole, Appellants, vs. Home Owners' Loan Corporation, a Corporation, Appellee. Transcript of Record. Upon Appeal

from the District Court of the United States for the Eastern District of Washington, Northern Division.

Filed July 31, 1941.

PAUL P. O'BRIEN,
Clerk of the United States Circuit Court of Appeals
for the Ninth Circuit.

In the United States Circuit Court of Appeals
For the Ninth Circuit

No. 9881

In the Matter of
JOHN THOMAS COLE and OMEGA TRICE
COLE, et ux
Farm Debtors and Appellants.

vs.

HOME OWNERS' LOAN CORPORATION,
Respondents.

STATEMENTS OF POINTS ON APPEAL
DIRECTION TO PRINT RECORD

Comes now, John Thomas Cole and Omega Trice Cole Farm Debtors and Petitioners in the above entitled cause, and present the following Statement of Points upon which they intend to rely upon their appeal from the decision of the United States District Court, made, and entered April 16, 1941 to-wit;

(1) Error in overruling petitioners' Demurrer to respondent's petition (for review).

(2) That said order is contrary to the laws of the United States pertaining to pleadings under the Amended Frazier-Lempke Act (11 U. S. C. A., Sec. 203; Act of June 22, 1938, Chapter 575 (75 a to s, 52 Stat. 840), providing for the relief of distressed farm debtors, and under which petitioners are seeking relief.

(3) Failure of said order to fix an appraised value and a rental value in the manner prescribed by the said Amended Frazier-Lempke Act, and in failing to confirm petitioners' right to occupation and possession of the farm property involved for a period of three (3) years, free from legal steps of ouster or dispossession, contingent on performance of and compliance with the order of the court with respect to rental and manner of occupation.

(4) That the recitals in said order of a valuation of \$5,250.00 is contrary to all the evidence received, supported by no testimony whatever, as shown by the record of the trial and the opinion of the Court.

(5) That there is no evidence which was introduced to support the statement contained in that portion of Paragraph I of said Order, following the word "Dollars", in line 5, page 2, being Paragraph I of said Order.

(6) That there is no support by evidence or testimony for the recital of Paragraph II of said order.

Further, the Appellants designate the entire record as heretofor filed, as necessary for consideration of the points on appeal, to-wit;

INDEX

Adjudication in Bankruptcy	9
Amended Debtor's Petition under Sec. 75 (s)...	5
Answer to Petition for Review.....	34
Bond for Costs on Appeal.....	57
Certificate of Clerk to Transcript of Record on Appeal	64
Demurrer to Petition for Review	31
Designation of Record on Appeal	60
Docket Entries of all proceedings before U. S. District Court.....	1
Exceptions of Farm Debtor to Order of 4/16/41	49
Inventory and Appraisement	14
Memorandum Opinion of the Court.....	36
Minute Entries of Hearing of 10/7/40.....	53
Minute Entries of Hearing of 10/8/40.....	54
Minute Entries of Hearing of 4/16/41.....	55
Notice of Appeal	56
Order approving Report of Conciliation Com- missioner and Terminating Proceedings be- fore him	4
Order appointing appraisers	13
Order approving Appraisal	32
Order granting motion for Extension of Time...	59
Order of April 16, 1941	45
Order of General Reference	10
Order Setting aside Exemptions	17
Petition (for Review)	20
Petition to set aside Exemptions.....	11
Statement of Points on Appeal	62
Stipulation of 8/16/40	33

Stipulation of 5/23/41	52
Substitution of Attorneys	51

CARL B. LUCKERATH

Counsel for Petitioners

Copy Received This 19 day of Aug. 1941.

PATTERSON & PATTERSON

Atty's for Defendant.

[Endorsed]: Filed Aug. 20, 1941. Paul P.
O'Brien, Clerk.

No. 9881

United States
Circuit Court of Appeals
For the Ninth Circuit

JOHN THOMAS COLE and OMEGA TRICE COLE,
Appellants,
—vs.—
HOME OWNERS' LOAN CORPORATION, a corporation,
Appellee.

UPON APPEAL FROM THE DISTRICT COURT OF THE
UNITED STATES FOR THE EASTERN DISTRICT
OF WASHINGTON, NORTHERN DIVISION.

APPELLANT'S OPENING BRIEF

CARL B. LUCKERATH,
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1173 Dexter-Horton Building
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FILED

OCT - 4 1941

PAUL P. O'BRIEN,
CLERK

SUBJECT INDEX

	<i>Page</i>
Statement of Jurisdiction.....	3
Statement of the Case.....	5
Specification of errors.....	6
Argument	7
Summary of Argument.....	7
Point A. Appellants, as farm debtors, are entitled to the entry of a stay which will assure them of possession for three years from date of the order, regardless of any possibility of rehabilitation	8
Point B. The order of the District Court setting the value of the farm property of appellants at \$5250.00 was not supported by the evidence.....	11
Point C. The order of the District Court finding that there is no possibility of rehabilitation was not supported by the evidence.....	12
Conclusion	13
Appendix	15

TABLE OF CASES CITED

Page

Borchard vs. California Bank; 310 U. S. 311, 84 L. Ed. 1222 60 Sup. Ct. 957.....	8, 9, 10
John Hancock Insurance Co. vs. Bartels; 308 U. S. 180, 84 L. Ed. 176, 60 Sup. Ct. 221...	8, 9, 10

TABLE OF STATUTES CITED

U. S. C. A. Title 11, Section 11 (U. S. Code, 1934 Edition, Supplement V, Title 11, Sec. 11).....	3
U. S. C. A. Title 11, Section 47 (U. S. Code 1934 Edition, Supplement V, Title 11, Section 47).....	3
U. S. C. A. Title 11, Section 203 (U. S. Code 1934 Edition, Supplement V, Title 11. Section 203).....	3, 5, 6, 8, 10, 15-20
U. S. C. A. Title 28, Section 41 (19) (U. S. Code 1934 Edition, Title 28, Section 41, subsec. 19).....	3
U. S. C. A. Title 28, section 225 (c) (U. S. Code 1934 Edition, Title 28, Section 225, subsec. c).....	3

STATEMENT AS TO JURISDICTION

This is a proceeding brought by a farmer under Section 75 of the Bankruptcy act (U.S.C.A. Title 11, Sec. 203.)

(1) The statutory provisions which sustain the jurisdictions are as follows:

(a) Sustaining the Jurisdiction of the District Court: U. S. Code, 1934 Edition, Title 28, section 41, subsection (19); and U. S. Code, 1934 Edition, Supplement V, Title 11, Section 11 and 203.

(b) Sustaining the jurisdiction of the Circuit Court of Appeals: U. S. Code, 1934 Edition, Title 28, Section 225(c); and U. S. Code, 1934 Edition, Supplement V, Title 11, Sections 47 and 203.

(2) The pleading necessary to show existence of the jurisdictions are as follows, with reference to page of record in which they appear:

AMENDED DEBTOR'S PETITION, Record pages 8-10;

PETITION TO SET ASIDE EXEMPTIONS, Record pages 14-15;

PETITION (For review of orders, Record pages 20-22, and 35), Record pages 20-34;

NOTICE OF APPEAL (From Order, Record pages 49-53), Record pages 60-61.

No. 9881

United States
Circuit Court of Appeals
For the Ninth Circuit

JOHN THOMAS COLE and OMEGA TRICE COLE,
Appellants,
—vs.—

HOME OWNERS' LOAN CORPORATION, a corporation,
Appellee.

APPELLANT'S OPENING BRIEF

STATEMENT OF THE CASE

Appellants are engaged in farming operations in Douglas County, Washington. Appellees have a mortgage on the farm real property of appellants. Appellants filed a petition for relief as farm debtors under Section 75 of the Bankruptcy Act, USCA Title 11, Sec. 203 and, failing to secure a composition and extension under agreement with the creditors, such original proceeding was dismissed and the appellants filed a petition to be adjudged bankrupts under Section 75(s).

Thereafter appraisers appraised the real estate as having a fair and reasonable market value of \$1,000.00 and the Conciliation Commissioner ordered that the appellants should have possession of the real property for three years and should pay \$115.00 annually as

rental. Appellees petitioned the district court for review, and such review being granted over appellants' demurrer, the district court set the value of the real estate at \$5250.00, refused to set a rental value thereon, and ordered an immediate sale, under Section 75(s) (3) of the Bankruptcy act. Appellants objected to the court's order setting the value at \$5250.00 as contrary to the evidence; and the order refusing to set a rental value on the real estate, refusing to allow appellants to have possession for three years and requiring an immediate sale thereof as contrary to the provisions of Section 75(s) of the Bankruptcy act, and appeal accordingly.

SPECIFICATIONS OF ERRORS

(1) Error in overruling petitioners' Demurrer to respondent's petition (for review).

(2) That the order of the Circuit Court (record pages 49 to 53) is contrary to the laws of the United States pertaining to pleadings under the Amended Frazier-Lempke Act (11 U.S.C.A., Sec. 203; Act of June 22, 1938, Chapter 575, 75a to s; 52 Stat. 840.) providing for the relief of distressed farm debtors, and under which petitioners are seeking relief.

(3) Failure of said order to fix an appraised value and a rental value in the manner prescribed by said

Amended Frazier-Lempke Act, and in failing to confirm petitioners' right to occupation and possession of the farm property involved for a period of three (3) years, free from legal steps of ouster or dispossession, contingent on performance of and compliance with the order of the court with respect to rental and manner of occupation.

(4) That the recitals in said order of a valuation of \$5,250.00 (Record pages 50-51) is contrary to all the evidence received, supported by no testimony whatever, as shown by the record of the trial and the opinion of the court.

(5) That there is no evidence which was introduced to support the statement contained in the portion of Paragraph I of said Order (Record pages 50 and 51) following the word "Dollars" on the first line of page 51 of the Record.

(6) That there is no support by evidence or testimony for the recital of Paragraph II of said order (page 51 of the Record).

ARGUMENT

SUMMARY OF ARGUMENT

POINT A. Appellants, as farm debtors, are entitled to the entry of a stay which will assure them of

possession for three years from the date of the order, regardless of any possibility of rehabilitation.

POINT B. The order of the District Court setting the value of the farm property of appellants at \$5250.00 was not supported by the evidence.

POINT C. The order of the District Court finding that there is no possibility of rehabilitation of the debtors was not supported by the evidence.

POINT A. APPELLANTS, AS FARM DEBTORS, ARE ENTITLED TO THE ENTRY OF A STAY WHICH WILL ASSURE THEM OF POSSESSION FOR THREE YEARS FROM THE DATE OF THE ORDER, REGARDLESS OF ANY POSSIBILITY OF REHABILITATION.

Section 75(s) of the Bankruptcy Act (11 U.S.C.A., Sec. 203s; Act of June 22, 1938, Chapter 575, Section 75s; 52 Stat. 840; pertinent parts of which are set out in the Appendix to this Brief) has been very clearly elucidated on this point by two cases: *John Hancock Insurance Co. vs. Bartels*, 308 U.S. 180, 84 L. Ed. 176, 60 S. Ct. 221; and *Borchard et al vs. California Bank*, 310 U.S. 311, 84 L. Ed. 1222, 60 S. Ct. 957. In each of these cases, the question being directly presented, it was held that a farm debtor, having made compliance with statutory provisions, is entitled to a stay of all proceeding against him or his property for a period of three years, and during that time the debtor may retain possession of all or part of his property subject

to the court's control. provided he pays a reasonable rental semi-annually, regardless of possibility of rehabilitation.

In the case of *Borchard vs. California Bank, supra*, the factual grounds for refusing the debtor the statutory stay of possession, were stronger than in the present case, for in that case, after the filing of the petition, the debtor was left in possession for almost three years upon stipulation before the District Court ordered the proceedings dismissed on the ground that the petitioners could not rehabilitate themselves. Such action was affirmed by the Circuit Court of Appeals. In reversing the case, the Supreme Court stated, page 317, as follows:

“No stay order has been entered fixing terms on which the debtors are to remain in possession. The petitioners were entitled to a compliance with the procedure required by the Statute. The bank, at any time, could have obtained action by the Conciliation Commissioner and the Court, in accordance with the statute. It cannot now maintain that the disorderly and unauthorized procedure followed by the parties is the equivalent of that prescribed by the statute and that, as the petitioners have not been able to rehabilitate themselves, it is entitled to enforce its liens.”

In *John Hancock Inc. Co. vs. Bartels, supra* (page 187) it was said:

“The scheme of the statute is designed to provide an orderly procedure so as to give whatever relief may properly be afforded to the distressed

farmer-debtor, while protecting the interests of his creditors by assuring the fair application of whatever property the debtor has to the payment of their claims, the priorities and liens of secured creditors being preserved."

This was quoted with approval in the decision in *Borchard vs. California Bank, supra* (page 317), which went on to say (page 318):

"That orderly procedure includes an application by the debtor, such as was made in the present case, for an appraisal of the property, an order that the debtor remain in possession upon terms fair and equitable to him and to secured creditors, and the entry of a stay which will assure him of his possession for three years from the date of the order, upon the conditions mentioned in the Act."

The purpose of Section 75 of the Bankruptcy Act is neatly explained in *John Hancock Insurance Co. vs. Bartels, supra*, at page 184:

"The subsections of Section 75 which regulate the procedure in relation to the effort of the farmer-debtor to obtain a composition or extension contain no provision for a dismissal because of the absence of a reasonable probability of the financial rehabilitation of the debtor. Nor is there anything in these subsections which warrants the imputation of a lack of good faith to a farmer-debtor because of that plight. The plain purpose of Section 75 was to afford relief to such debtors who found themselves in economic distress however severe, by giving them the chance to seek an agreement with their creditors (subsections (a) to (r)) and, failing this, to ask for other relief

afforded by subsection (s). The farmer-debtor may offer to pay what he can as Bartels did, and he is not to be charged with bad faith in taking the course which the statute expressly provides.”

It is submitted that these two decisions are conclusive upon the present case.

POINT B. THE ORDER OF THE DISTRICT COURT SETTING THE VALUE OF THE FARM PROPERTY OF APPELLANTS AT \$5250.00 WAS NOT SUPPORTED BY THE EVIDENCE.

The Inventory and Appraisement appears on pages 17 to 19 of the Record, setting the value of the farm property of appellants at \$1000.00. The order approving said appraisal appears on page 35 of the record, order setting aside exemptions appears on pages 20 to 22 of the Record. The minutes of the hearing in the District Court, on the basis of which hearing the Memorandum opinion (Record pages 39-49) and the order complained of were made, appear on page 58 and 59 of the record. The memorandum opinion recites (Record page 40) that “it was stipulated that” a certain appraiser of the petitioner (appellee here), if personally present would testify that the fair and reasonable cash market value was at least \$5250.00. No stipulation to such effect appears in the record, though a stipulation on another matter (record page 58) was entered. Moreover the unnamed appraiser, even if

testifying, was an employee of appellee, and his testimony subject to discount. The memorandum opinion (record page 44) shows that all witnesses who actually testified set the value substantially in agreement with that set by the appraisers. The opinion states (Record page 44, tenth line from bottom) "The court believes these witnesses were in good faith . . ." That being so, it is suggested that the district court acted very arbitrarily in rejecting such evidence, given in good faith, upon what an unidentified person might have testified to, if present.

It seems strange that the court should put so much faith in the spectral testimony of a mysterious stranger, whose name appears nowhere, and who must have had seven-league boots and the eyes of Argus to do the amount of appraising stated (Record page 40).

POINT C. THE ORDER OF THE DISTRICT COURT FINDING THAT HERE IS NO POSSIBILITY OF REHABILITATION WAS NOT SUPPORTED BY THE EVIDENCE.

The finding referred to is on Page 51 of the Record. The only thing appearing to support this finding is in the memorandum opinion, page 46 and 47 of the record. It is submitted that those statements alone, are insufficient to support any such finding. It would seem

that, with the appellant managing other farms besides his own (page 46 of the record) that he is making an effort for rehabilitation, with a distinct possibility of success.

CONCLUSION

It is therefore respectfully submitted that this court should reverse the decision of the District Court, with instructions to confirm the Conciliation Commissioner's Order Setting Aside Exemptions (pages 20-22 of the Record).

CARL B. LUCKERATH,
Counsel for Appellant

APPENDIX

U.S.C.A. Title 11, Sec. 203 (s); U. S. Code 1934, Supplement V, Title 11, Sec. 203 (s); Act of June 22, 1938, Chapter 575, 75 (s); 52 Stat. 840:

Any farmer failing to obtain the acceptance of a majority in number and amount of all creditors whose claims are effected by a composition and/or extension proposal, or if he feels aggrieved by the composition and/or extension, may amend his petition or answer, asking to be adjudged a bankrupt. Such a farmer may, at the same time, or at the time of the first hearing, petition the court that all of his property, wherever located, whether pledged, encumbered, or unencumbered, be appraised, and that his unencumbered exemptions, and unencumbered interest or equity in his exemptions, as prescribed by State law, be set aside to him, and that he be allowed to retain possession, under the supervision and control of the court, of any part or parcel or all of the remainder of his property, including his encumbered exemptions, under the terms and conditions set forth in this section. Upon such a request being made the referee, under the jurisdiction of the court, shall designate and appoint appraisers, as provided for in this title. Such appraisers shall appraise all of the property of the debtor, wherever

located, at its then fair and reasonable market value. The appraisals shall be made in all other respects with rights of objections, exceptions and appeals, in accordance with this title: *Provided* that in proceedings under this section, either party may file objections exceptions, and take appeals, within four months from date that the referee approves the appraisal.

(1) After the value of the debtors property shall have been fixed by the appraisal herein provided, the referee shall issue an order setting aside, to such a debtor his unencumbered exemptions, and his unencumbered interest or equity in his exemptions, as prescribed by the State Law, and shall further order that the possession, under the supervision and control of the court, of any part or parcel or all of the remainder of the debtor's property shall remain in the debtor, as herein provided for, subject to all existing mortgages, liens, pledges, or encumbrances. All such existing mortgages, liens, pledges, or encumbrances shall remain in full force and effect, and the property covered by such mortgages, liens, pledges, or encumbrances shall be subject to the payment of the claims of the secured creditors, as their interests may appear.

(2) When the conditions set forth in this section have been complied with, the court shall stay all judicial or official proceedings in any court, or under the

direction of any official, against the debtor or any of his property, for a period of three years. During such three years the debtor shall be permitted to retain possession of all or any part of his property, in the custody and under the supervision and control of the court, provided he pays a reasonable rental semi-annually for that part of the property of which he retains possession. The first payment of such rental shall be made within one year of the date of the order staying proceedings, the amount and kind of such rental to be the usual customary rental in the community where the property is located, based upon the rental value, net income, and earning capacity of the property. Such rental shall be paid into court, to be used, first, for payment of taxes and upkeep of the property, and the remainder to be distributed among the secured and unsecured creditors, and applied to their claims, as their interests may appear. The court, in its discretion, if it deems it necessary to protect the creditors, from loss by the estate, and/or to conserve the security, may order sold any unexempt perishable property of the debtor, or any unexempt personal property not reasonably necessary for the farming operations of the debtor, such sale to be had at private or public sale, and may in addition to the rental, require payments on the principal due and owing by the debtor to the

secured or unsecured creditors, as their interests may appear, in accordance with the provisions of this title, and may require such payments to be made quarterly, semi-annually, or annually, not inconsistent with the protection of the rights of the creditors and the debtors ability to pay, with a view to his financial rehabilitation.

(3) At the end of the three years, or prior thereto, the debtor may pay into court the amount of the appraisal of the property of which he retains possession, including the amount of the encumbrances on his exemptions, up to the amount of the appraisal, less the amount paid on the principal; *Provided*, that upon request of any secured or unsecured creditor, or upon request of the debtor, the court shall cause a reappraisal of the debtor's property, or in its discretion set a date for hearing, and after such hearing, fix the value of the property in accordance with the evidence submitted, and the debtor shall then pay the value so arrived at into court, less payments made on the principal, for distribution to all secured and unsecured creditors, as their interests may appear, and thereupon the court shall, by an order, turn over full possession and title of said property, free and clear of encumbrances to the debtor: *Provided*, that upon request in writing by a secured creditor or creditors,

the court shall order the property upon which said secured creditors have a lien to be sold at public auction. The debtor shall have ninety days to redeem any property sold at such sale, by paying the amount for which any such property was sold, together with five (5%) per centum per annum interest, into court, and he may apply for his discharge, as provided for by this title. If, however, the debtor at any time fails to comply with the provisions of this section, or with any orders of the court made pursuant to this section, or is unable to refinance himself within three years, the court may order the appointment of a trustee, and order the property sold or otherwise disposed of as provided for in this title.

(4) The conciliation commissioner appointed under subsection (2) of this section, as amended, shall continue to act, and act as referee, when the farmer-debtor amends his petition or answer, asking to be adjudged a bankrupt under the provisions of this subsection, and continue so to act until the case has been finally disposed of, the conciliation commissioner, as such referee, shall receive such an additional fee for his services as may be allowed by the court, not to exceed \$35.00 in any case, to be paid out of the bankrupt's estate. No additional fees or costs of administration or supervision of any kind shall be

charged to the farmer-debtor, when or after he amends his petition or answer, asking to be adjudged a bankrupt, under this subsection, but all such additional filing fees or cost of administration or supervision shall be charged against the bankrupt's estate. Conciliation commissioners and referees appointed under this section shall be entitled to transmit in the mails, free of postage, under cover of a penalty envelope, all matters which relate exclusively to the business of the courts, including notices to creditors. If at the time that the farmer debtor amends his petition or answer, asking to be adjudged a bankrupt, a receiver is in charge of any of his property such receiver shall be divested of possession and the property returned to the possession of such farmer, under the provisions of this title. The provisions of this title shall be held to apply also to partnerships, common, entirety, joint, community ownership, or to farming corporations where at least seventy-five (75%) per centum of the stock is owned by actual farmers, and any such parties may join in one petition.

IN THE
UNITED STATES
CIRCUIT COURT OF APPEALS

For the Ninth Circuit

JOHN THOMAS COLE and OMEGA TRICE COLE,
Appellants,
vs.
HOME OWNERS' LOAN CORPORATION, a corporation,
Appellee.

UPON APPEAL FROM THE DISTRICT COURT OF THE
UNITED STATES FOR THE EASTERN DISTRICT OF
WASHINGTON, NORTHERN DIVISION

HONORABLE LLOYD L. BLACK, *Judge*

APPELLEE'S BRIEF

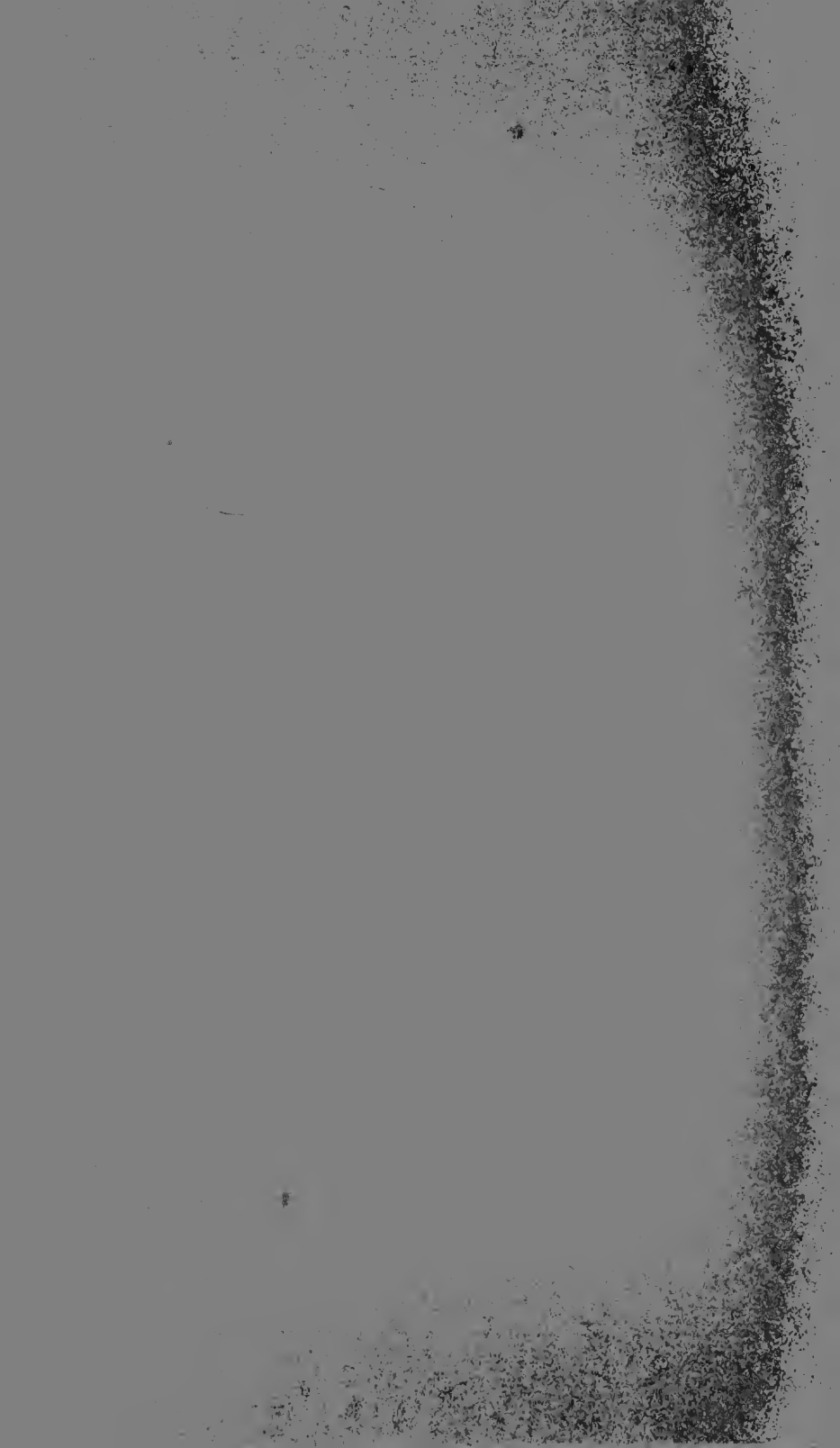
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NOV - 2 1941

PAUL P. O'BRIEN,
CLERK

TOM S. PATTERSON
Counsel for Appellee

1921 Smith Tower
Seattle, Washington



IN THE
UNITED STATES
CIRCUIT COURT OF APPEALS

For the Ninth Circuit

JOHN THOMAS COLE and OMEGA TRICE COLE,

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HOME OWNERS' LOAN CORPORATION, a corporation,

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UPON APPEAL FROM THE DISTRICT COURT OF THE
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HONORABLE LLOYD L. BLACK, *Judge*

APPELLEE'S BRIEF

TOM S. PATTERSON

Counsel for Appellee

1921 Smith Tower
Seattle, Washington



SUBJECT INDEX

PAGE

Statement of the Case..... 1

Argument..... 3



TABLE OF CASES CITED

	PAGE
<i>Borchard vs. California Bank</i> ; 310 U. S. 311, 84 L. Ed. 1222 60 Sup. Ct. 957.....	5
<i>Dombrowski vs. Beu</i> ; 114 Fed. 2nd 91	3
<i>John Hancock Insurance Co. vs. Bartels</i> ; 308 U. S. 180, 84 L. Ed. 176, 60 Sup. Ct. 221.....	5
<i>Reconstruction Finance Corporation vs. Herring</i> ; 110 Fed. 2nd 320.....	3
<i>Wright vs. Union Central Liwe Insurance Company</i> ; 311 U. S. 273, 61 Sup. Ct. 196, 85 L. Ed.....	4
<i>Wright vs. Vinton, Branch, etc.</i> ; 57 Sup. Ct. 556, 300 U. S. 440, 81 L. Ed. 736.....	4

TABLE OF STATUTES CITED

	PAGE
U. S. C. A. Title 11 203 (s) Section 75 S of Bankruptcy Act.....	1



IN THE
UNITED STATES
CIRCUIT COURT OF APPEALS
For the Ninth Circuit

JOHN THOMAS COLE and OMEGA TRICE COLE,

Appellants,

vs.

HOME OWNERS' LOAN CORPORATION, a corporation,

Appellee.

UPON APPEAL FROM THE DISTRICT COURT OF THE
UNITED STATES FOR THE EASTERN DISTRICT OF
WASHINGTON, NORTHERN DIVISION

HONORABLE LLOYD L. BLACK, *Judge*

APPELLEE'S BRIEF

STATEMENT OF THE CASE

This is an appeal in a proceeding under the Frazier-Lempke Act (Section 75 S of the Bankruptcy Act, 11 U. S. C. A. 203(s)) from an order of the District Court entered prior to the expiration

of the three-year stay period provided by the act, fixing the appraised value of certain farm property of the appellants upon which the appellee holds a mortgage, allowing the appellants a specified time prior to sale for redeeming the property at the appraised value and providing in the event the appraised value shall not be paid prior to the expiration of that time, that the property in question shall be sold subject to redemption as provided in the order.

The farm debtors' amended petition was filed March 9, 1940, order of adjudication and reference was entered the same day, order allowing the debtors to retain possession was entered March 13, 1940, and the order appealed from was entered April 16, 1941. The order appealed from recites in part:

“ it was stipulated in open court that the court might hear and determine the issues presented by the petition of said Home Owners' Loan Corporation, and subsequent pleadings, upon their merits and that all objections to the form of procedure were waived . . . and the court heard evidence on behalf of the respective parties . . . and took the matter under advisement . . . that a reasonable annual rental for the use of said property would not be less than \$400.00, but that inasmuch as the farm debtors have evidenced lack of interest in paying more than enough to cover taxes and water

charges against the property it does not appear to the court necessary to the disposition of the property to fix the annual rent . . . That there is no possibility of rehabilitation of the farm debtors, nor does their testimony permit the inference that they expect or desire the same."

Trial of the proceedings in the lower court consumed in excess of a day; a substantial amount of evidence, both oral and documentary, was introduced on behalf of each of the parties. None of this evidence is before this court on this appeal.

ARGUMENT

An examination of the points raised by appellants seems to disclose that the consist entirely of the contention urged in various forms that the order appealed from is contrary to the evidence or not sustained by the evidence. The rule, however, appears to be that contentions of this character will not be passed on in the absence of the evidence and that it will be presumed that the evidence supports the judgment or order appealed from. *Dombrowski vs. Beu*, 114 Fed. 2nd 91, and see *Reconstruction Finance Corporation vs. Herring*, 110 Fed. 2nd 320.

Appellee has no disposition to evade a discussion of the justice or propriety of the order appealed from, but it appears self-evident that in the absence of the evidence upon which such order is based appellee is in no position to enter upon such a discussion.

That an order of this kind may be entered prior to the expiration of the three year period under proper circumstances appears to have been definitely settled by the Supreme Court of the United States in Wright vs. Union Central Life Insurance Company, 311 U. S. 273, 61 S. Ct. 196, 85 L. Ed. Such also was the holding of the Supreme Court in the earlier case of Wright vs. Vinton, Branch, etc., 57 S. Ct., 556, 300 U. S. 440, 81 L. Ed. 736, upholding the constitutionality of the act in question upon the specific ground, among others, that the act did not provide for an absolute stay for three years, but authorized an earlier termination in the discretion of the court.

In the Wright vs. Union Central Life Insurance Company case, supra, the Court approved the entry of an order terminating the stay period and directing a sale prior to the expiration of the three-year period. In this latter case it appears the order appealed from contained no provision allowing the farm debtor to buy the property at the appraised value prior to sale, and the order there under consideration was directed to be modified by the insertion of such a provision therein, and as modified allowed to stand. It is believed that the order appealed from here contains (Par. III-Page 51 of transcript) a provision which meets the requirements of the above case.

It is respectfully submitted that upon the author-

ity of the above cases the order appealed from on the record here ought to be affirmed.

The only two cases cited in appellants' brief are *Borchard vs. California Bank*, 310 U. S. 311, 84 L. Ed. 1222, 60 S. Ct. 95, and *John Hancock Insurance Company vs. Bartels*, 308 U. S. 180, 84 L. Ed. 176, 60 S. Ct. 221. To appellants at least, the decision in each of these cases seems to be predicated upon the proposition that the procedure provided for by the statute had not been followed. The statute provides in substance that any farmer failing to obtain acceptance of his proposal may amend his petition and ask to be adjudged a bankrupt, that his exempt property be set off to him and that he be allowed to retain the possession of the remainder of his property under the supervision and control of the court; that thereupon the referee shall appoint appraisers who shall appraise the property, and that after the value shall have been fixed by appraisal, the referee shall set off to the bankrupt his exemptions and shall further order that the possession of the remainder of the debtor's property shall remain in the debtor under the supervision of the court. In neither the *John Hancock* case nor the *Borchard* case was this done. In the *John Hancock* case the petition was dismissed at the threshold, i.e., before any reference to the referee at all. In the *Borchard* case the matter was referred to the referee, but no stay order was entered, and the

mortgagee acquiesced for a period of nearly three years in the failure to enter such an order.

In the instant case it appears on the face of the record that the procedure laid down by the statute has been followed, i.e., the matter was referred to the referee; an appraisal was had and a stay order entered, and it was not until over a year after all this had been done that the order appealed from here was entered.

It is respectfully submitted that the order appealed from should be affirmed.

Respectfully,

TOM S. PATTERSON

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Seattle, Washington

No. 9881

13

United States
Circuit Court of Appeals
For the Ninth Circuit

JOHN THOMAS COLE and OMEGA TRICE COLE,
Appellants,

vs.

HOME OWNERS' LOAN CORPORATION, a corporation,
Appellee.

UPON APPEAL FROM THE DISTRICT COURT OF THE
UNITED STATES FOR THE EASTERN DISTRICT OF
WASHINGTON, NORTHERN DIVISION

APPELLANT'S REPLY BRIEF

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FILED

NOV 25 1941

PAUL P. O'BRIEN,

CLERK

NOV 25 1941

PAUL P. O'BRIEN,

SUBJECT INDEX

	<i>Page</i>
Argument	1

TABLE OF CASES CITED

In Re Wright, 108 Federal (2nd) 361.....	2
John Hancock Insurance Co. vs. Bartels, 308 U. S. 180, 84 L. Ed. 176, 60 Sup. Ct. 221.....	1
Wright vs. Union Central Life Insurance Co. 311 U. S. 273, 61 Sup. Ct. 196.....	1
Wright vs. Vinton Branch, etc. 57 Sup. Ct. 556. 300 U. S. 440, 81 L. Ed. 736.....	1

TABLE OF STATUTES CITED

U.S.C.A. Title 11 Sec. 203 (s) (3) ; section 75 (s) (3) of the Bankruptcy Act.....	2
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No. 9881

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Appellee.

APPELLANT'S REPLY BRIEF

ARGUMENT

It is submitted that the inferences drawn by counsel for appellees from the cases cited by him are erroneous:

Statements in *Wright vs. Vinton Branch*, etc., 57 S. Ct. 556, 300 U. S. 440, 81 L. Ed. 736, relied upon him, were *obiter dicta*, and were overruled by the decision in *John Hancock Insurance Co. vs. Bartels*, 308 U. S. 180, 84 L. Ed. 176, 60 Sup. Ct. 221.

In *Wright vs. Union Central Life Insurance Company*, 311 U. S. 273, 61 S. Ct. 196, also cited by counsel for appellee, the court stated, in the first paragraph of the opinion: "The narrow issue presented by this

petition for *certiorari* and which moved us to grant it is whether under 75 (s) (3) the debtor must be accorded an opportunity, on his request, to redeem the property at the reappraised value or at a value fixed by the court before the court may order a public sale." If that, then, is the narrow issue, how can the case be cited as proving anything else? In that particular case, the proceedings were terminated prior to the expiration of three years because the petitioner had repeatedly failed and refused to comply with the orders of court and the terms under which he held possession. See *In Re Wright*, 108 Federal (2nd) 361, from which the appeal was taken. In the present case, appellants have never failed to comply with the law or orders of court.

The provisions of Section 75 (s) (3) of the Bankruptcy act do not provide acceleration of the three year period any time the court believes, from the evidence before it, that the farmer-debtor cannot rehabilitate himself in three years. The clear meaning of the statute, and the interpretation of the Supreme Court of the United States, is that the only way to determine whether or not any given farmer, who complies with

the law and proper orders of court, can rehabilitate himself in three years of possession under a stay order is to give him a full three years of possession thereunder.

Respectfully,

CARL B. LUCKERATH,
Counsel for Appellant.

108 + 28

No. 9881

14

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UPON APPEAL FROM THE DISTRICT COURT OF THE
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APPELLANT'S PETITION FOR REHEARING

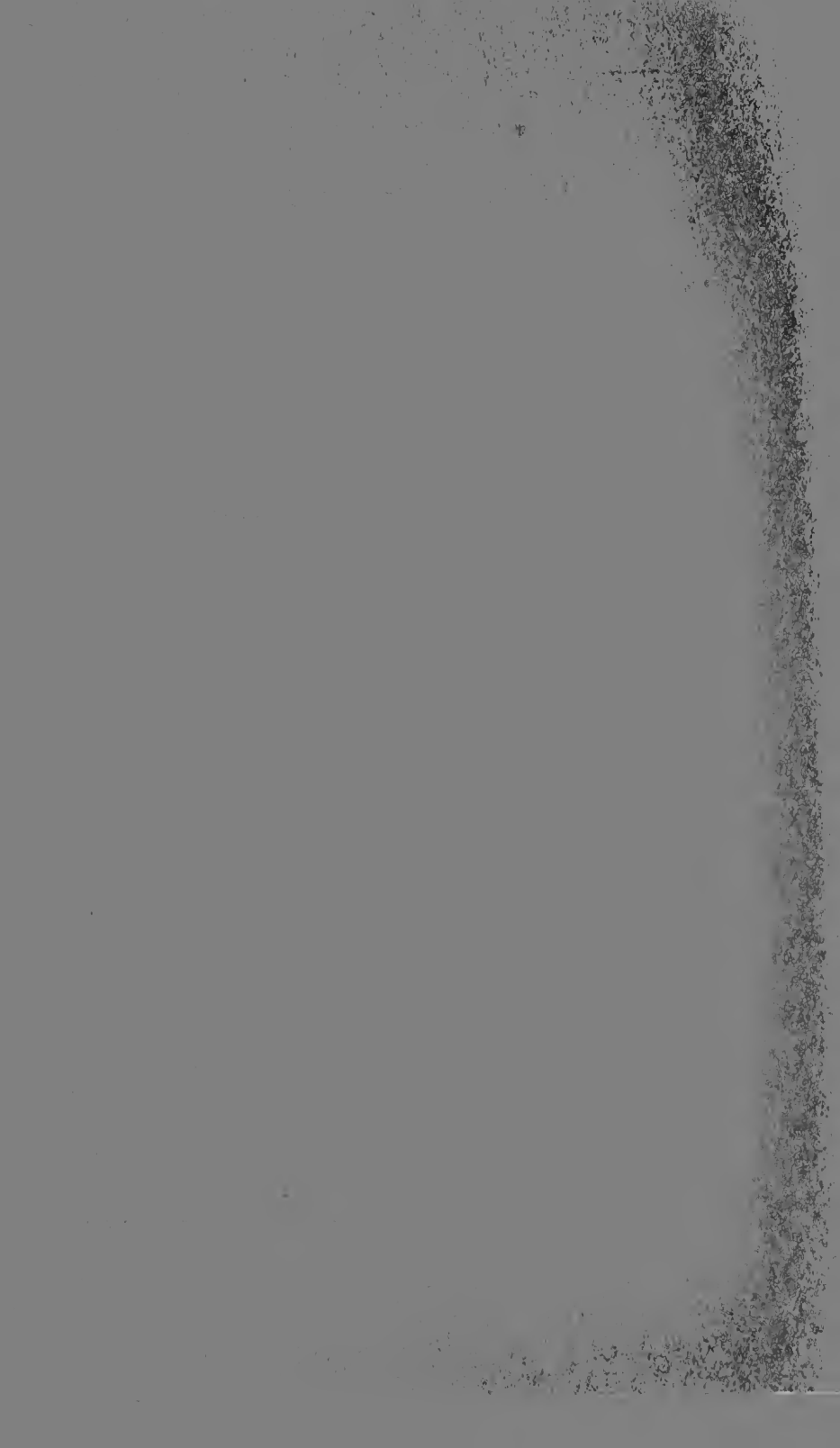
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FILED

JUL 15 1942

PAUL P. O'BRIEN,
CLERK



SUBJECT INDEX

	<i>Page</i>
I. IT IS RESPECTFULYY SUBMITTED THAT THE CIRCUIT COURT HAS MIS-UNDERSTOOD THE STATEMENTS AND FINDINGS OF THE LOWER COURT AS CONTAINED IN ITS MEMORANDUM OPINION (Tr. p. 47) AND ORDER (Tr. p. 51)	1
II. THE DOCTRINE OF WAIVER, AS SET FORTH IN THIS CASE, SETS A DANGEROUT PRECEDENT, AND MAY CAUSE THE COURTS OF THE UNITED STATES A GREAT DEAL OF TROUBLE FOR YEARS TO COME	7
III. BY WAY OF CLIMAX APPELLANTS WISH RESPECTFULLY BUT FORCIBLY TO CALL ATTENTION TO THE FACT THAT WHILE THIS APPEAL WAS PENDING THE LOWER COURT SPECIFICALLY ORDERED THE FARM DEBTORS TO PAY THE SUM OF \$550.00, not \$400.00, INTO THE REGISTRY OF THE COURT IN LIEU OF RENTAL AND SAID SUM OF \$550.00 WAS PAID!.....	8
IV. CONCLUSION	9
CERTIFICATION	11

TABLE OF CASES CITED

Wright v. Union Central Life Insurance Co., 311 U. S. 273, 61 Sup. Ct. 196	10
John Hancock Insurance Co. v. Bartels, 308 U. S. 180 84 L. Ed. 176, 60 Sup. Ct. 221.....	10
Kalb v. Feuerstein, 308 U. S. 433.....	10
Dombrowski v. Beu, 114 Fe. 2d. 91.....	3



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APPELLANT'S PETITION FOR REHEARING

- I. IT IS RESPECTFULLY SUBMITTED THAT THE CIRCUIT COURT HAS MISUNDERSTOOD THE STATEMENTS AND FINDINGS OF THE LOWER COURT AS CONTAINED IN ITS MEMORANDUM OPINION (Tr. p. 47) AND ORDER (Tr. p. 51)

The pertinent language of the Lower Court from which this error flows is in its memorandum opinion (Tr. 47.) as follows:

"The Court deems \$115.00 annually far below the rental value of the real estate and deems insufficient any annual rental less than \$400.00 But since the debtors *evidenced lack of interest* in paying more than merely enough to cover taxes and water charges it does not appear necessary to the disposition of the property to fix the proper rental." (Italics ours)

This language is repeated substantially in the order (Tr. p. 51) with the addition that the sum of \$400.00 is referred to as “reasonable.”

The Lower Court specifically states the *evidence* upon which it relies at two or more places:

“His testimony, in effect, was that there was no rental value to the property at all other than taxes and water (LLB) and that he at the present time had the complete use and possession of four similar properties by merely paying the taxes and water or less and could secure additional orchards under similar arrangements” (Tr. p. 43 bottom) “Under the *contentions and testimony* of the farm debtor”

(And same as preceding quotation in different language at page 46 center)

The debtors were given no chance to accept the \$400.00 rental at the time of the delivery of the opinion because the Court immediately forecloses them by saying although this sum is reasonable it is not necessary to set any rental at all.

Yet the Circuit Court states in its opinion (Top p. 4):

“The debtors’ declaration that they would not pay \$400 rental must be considered a waiver of *their right* to have the trial court fix the exact amount of the rental to be paid if the court found it to be over four hundred dollars.” (Italics ours)

But it is clear that the first mention of the sum of \$400.00 for rental appears in the trial court's memorandum. It should be kept in mind that the hearing took place on October 28, 1940. Briefs were submitted, and memorandum opinion was delivered on February 26, 1941, and the order pursuant thereto signed on April 17, 1941. If the debtors had made an outright refusal to pay \$400.00 or any other sum in open court, why go to all this trouble and delay? At no point in the trial court's memorandum opinion is it stated that debtors were given a chance to affirm or deny a tentative order or proposal of the Court. On the contrary the trial court gave the debtors no opportunity to turn down or accept a definite proposition but rested its opinion on the facts referred to in the quotations *supra*. If the facts were stronger the trial would and should have mentioned them. Parenthetically it might be considered equitable that if the trial court needed to take the case under advisement to determine a reasonable rental then the debtors should be given the same privilege.

Because of the foregoing analysis the Court cannot be assisted by citing *Dombrowski v. Beu*, 114 F. 2d. 91, to the effect that the evidence not having been brought before the Higher Court it must be presumed to be suf-

ficient to support a finding of the Lower Court when, as shown, the Lower Court has stated all the facts upon which it bases its finding, although in truth it is no finding of fact at all but is an inference or conclusion. Likewise the presumption contended for as the legal principle of the Dombrowski case comes in conflict with the question of law as to whether a litigant can waive his case unknowingly from the witness stand as hereafter set forth.

The true facts of the principal case may be said of have become enlarged like the joints of a telescope, as follows:

1. One of the debtors testifies that he can get other farms of equal grade as his own for taxes and water charges and that his farm has practically no commercial value. (Tr. pp. 43 and 46)

2. The Lower Court interprets this as "evidencing lack of interest" to pay more on this home farm, and misleadingly groups in the same sentence its opinion that \$400.00 rental is reasonable." (Tr. pp. 47 and 51)

3. The Circuit Court, in turn, widens the Lower Court's language by stating the debtors declared they were not interested in paying the rental which the Court determined was reasonable (Op. p. 3); and

4. Later in the same paragraph states that debtors made a declaration they would not pay the specific sum of \$400.00. (Op. p. 4)

Thus, by a series of inferences, each based upon the one preceding, the final inference is a magnified distortion of the true facts. The errors are twofold:

1. The debtors are inferred to have made a *declaration* as opposed to *evidencing lack of interest*.

2. The debtors declaration or evidencing lack of interest is inferred to apply to the specific sum of \$400.00.

A *declaration* implies a formal statement with reference to a specific proposition, and in a trial would usually be made by counsel on behalf of his clients.

Having evidenced lack of interest indicates a general attitude only.

Any reasoning that the debtors having lacked of interest in paying more than taxes and water charges in the sum of \$115.00 (Tr. p. 47) must as a matter of logic be held to likewise not interested in paying the greater specific sum of \$400.00 is fallacious because of any of the following reasons:

1. Although said \$400.00 is practically four times the smaller sum yet it is a small sum in itself. The

materiality of the difference, \$285.00, is not the ratio between the two figures, but must be compared to other resources of the debtors, their necessity to live some place etc. . . . The difference amounts to less than \$25.00 per month.

2. The lower figure was the amount for which the litigant was contending the Court to set. Of necessity under our adversary system of law the contentions of the respective parties are wide apart and one side or the other must alter its position when the Judge decides an issue. Is there any doubt that the creditor would think \$400 too low? The debtors were obligated by their mortgage to pay the creditor \$88.53 per month (Tr. p. 42) which totals \$1162.36 per year. If we add to this \$115.00 for taxes and water the debtors total obligation was \$1287.36 or three times the amount the trial court indicated was reasonable. Would the creditor be satisfied? Would the creditor lose all of his other rights in court because it contended for three times the amount the trial court thought was reasonable or because it had testimony to that effect on the witness stand?

3. The property in question was the debtors' home of twenty-two years. This undoubtedly would influence appellants or anyone else to pay a greater sum than

the commercial value of the farm, regardless of the fact that the understood purpose of the Frazier-Lemke Act in great part is to enable farmers to retain their homes by paying for the commercial not sentimental values of the same.

4. The debtor did pay the sum of \$550.00 into the registry of the Court in lieu of rental as will be later set forth.

II. THE DOCTRINE OF WAIVER, AS SET FORTH IN THIS CASE, SETS A DANGEROUS PRECEDENT, AND MAY CAUSE THE COURTS OF THE UNITED STATES A GREAT DEAL OF TROUBLE FOR YEARS TO COME.

As shown by the quotations *supra* this "waiver" by the farm debtors was supposed to have occurred during the testimony of the debtor husband on the witness stand. It was not a written document or formal statement of counsel in open court. Certainly no claim can be made that counsel for the debtors formally refused on their behalf to pay the sum of \$400.00 or any other sum specifically suggested. The transcript herein contains all of the written documents in the record. The minutes of the Clerk (Tr. p. 58-59) make no mention of a formal waiver in open court although these minutes do contain other minor stipulations. It

would be preposterous to believe that the testimony of any other witness could be a waiver on the farm debtors' behalf.

Such a doctrine is contrary to all existing codes of justice. The essence of our law is impregnated with the principle that a citizen is entitled to notice before losing any of his rights or privileges.

But according to this doctrine, while under a strain of being on the witness stand, perhaps upon cross-examination of opposing counsel, and without knowing what is at stake, a harassed litigant can "waive" himself out of court and not know it until a year and one-half later.

It should be emphasized, that the "waiver" in question is not as to a minor point, but to the entire lawsuit. When one considers the carefulness of the Federal Courts, even in the matter of taking a default judgment against a defendant who has not responded to process or in the formal signing of orders for each step of procedure, it seems astounding that the Court would here countenance an informal "waiver" without some notice to the unfortunate litigant prior to his giving up valuable rights...

III. BY WAY OF CLIMAX APPELLANT'S WISH
RESPECTFULLY BUT FORCIBLY TO CALL

ATTENTION TO THE FACT THAT WHILE THIS APPEAL WAS PENDING THE LOWER COURT SPECIFICALLY ORDERED THE FARM DEBTORS TO PAY THE SUM OF \$550.00, not \$400.00, INTO THE REGISTRY OF THE COURT IN LIEU OF RENTAL AND SAID SUM OF \$550.00 PAID!

Appellants have requested the Clerk of the Court to certify to this fact and to file the same herewith. However, if this method of proof is not technically proper or satisfactory, it is a point that can easily be verified and should be verified so that the Court will be in the position of dispensing justice not only in theory but in fact.

IV. CONCLUSION.

It is respectfully submitted that the Frazier-Lemke Act would be a nullity if trial judges were permitted to speculate on whether or not a farm debtor could rehabilitate himself or whether or not a farm debtor will comply with an order or has waived the benefits of the act by his testimony or his contentions before the court has issued a specific order. The fundamental idea behind this legislation is to give the debtor an opportunity. It is therefore mandatory upon the trial court to set the terms of this opportunity, including the fixing of rental and a grant of possession for three years. If the debtor then fails to comply or if he then

waives his opportunity, there are prescribed remedies against him. To anticipate his action by a different unannounced procedure is to make the courts a mockery. As stated in *Wright v. Union Central Life Insurance Co.*, 311 U. S. 273, 61 Sup. Ct. 196, in the fifth paragraph thereof, which case cites *John Hancock Insurance Co. v. Bartels*, 308 U. S. 180, 84 L. Ed. 176, 60 Sup. Ct. 221, and *Kalb v. Feuerstein*, 308 U. S. 433.

“ . . . the Act must be liberally construed to give the debtor the full measure of the relief afforded by Congress, . . . lest its benefits be frittered away by narrow formalistic interpretations which disregard the spirit and letter of the Act.”

Therefore Appellants respectfully urge this Court to reconsider its opinion and to reverse the decision of the District Court, with instructions to confirm the Conciliation Commissioner's Order Setting Aside Exemptions (pages 20-22 of the Transcript of Record)

CARL B. LUCKERATH,
Counsel for Appellant.

UNITED STATES CIRCUIT COURT OF APPEALS
FOR THE NINTH CIRCUIT

JOHN THOMAS COLE and OMEGA
TRICE COLE,

Appellants,

- vs -

HOME OWNERS' LOAN CORPORA-
TION, a corporation,

Appellee.

No. 9881

CERTIFICATION

UNITED STATES OF AMERICA,
WESTERN DISTRICT OF WASHINGTON } ss.

I, CARL B. LUCKERATH, attorney of record for JOHN THOMAS COLE and OMEGA TRICE COLE, appellants in above entitled case, do hereby certify that the Petition for Rehearing contained herein is not made for the purpose of delay, but is made in good faith, both by said appellants and their attorneys.

Witness my hand and seal this 11th day of July, 1942.

CARL B. LUCKERATH

By ALECDUFF



